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Arab World Edition

Auditing and Assurance Services

Arens Elder Beasley Hegazy
Summary of the Audit Process

**PHASE I**
Plan and design an audit approach

- Accept client and perform initial planning
- Understand the client’s business and industry
- Assess client business risk
- Perform preliminary analytical procedures
- Set materiality and assess acceptable audit risk and inherent risk
- Understand internal control and assess control risk
- Gather information to assess fraud risk
- Develop overall audit plan and audit program

**PHASE II**
Perform tests of controls and substantive tests of transactions

- Plan to reduce assessed level of control risk?
- Yes
  - Perform tests of controls
  - Perform substantive tests of transactions
  - Assess likelihood of misstatements in financial statements
- No

**PHASE III**
Perform analytical procedures and tests of details of balances

- Low
  - Perform analytical procedures
- Medium
  - Perform tests of key items
- High or unknown
  - Perform additional tests of details of balances

**PHASE IV**
Complete the audit and issue an audit report

- Perform additional tests for presentation and disclosure
- Accumulate final evidence
- Evaluate results
- Issue audit report
- Communicate with audit committee and management

*The extent of testing of controls is determined by planned reliance on controls. For public companies in the U.S., testing must be sufficient to issue an opinion on internal control over financial reporting.*
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- Auditing and Assurance Services—Arens

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INTERNAL AND OPERATIONAL AUDITING

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Auditing and Assurance Services: Arab World Edition is an introduction to auditing and other assurance services aimed specifically at students studying in the region. It is intended for either a one-quarter or one-semester course at the undergraduate or graduate level. This book is also appropriate for introductory professional development courses for CPA firms, internal auditors, and government auditors.

The primary emphasis in this text is on the auditor’s decision-making process during an audit of financial statements. We believe that the most fundamental concepts in auditing concern determining the nature and amount of evidence the auditor should gather after considering the unique circumstances of each engagement. If students of auditing understand the objectives to be accomplished in a given audit area, the risks related to the engagement, and the decisions to be made, they should be able to determine the appropriate evidence to gather and how to evaluate the evidence obtained.

Our objective is to provide up-to-date coverage of auditing concepts with practical examples about the implementation of those concepts in real-world settings—both internationally and within the Arab world. The collective experience of the author team in the practice of auditing is extensive. All four authors have worked in the auditing profession, in large international audit firms as well as regional firms. All four authors have frequently taught continuing education for either large international or small CPA firms and one has extensive practice and experience within the Arab world. Three of the authors have been involved in standards setting activities of the Auditing Standards Board and the PCAOB, and one currently serves as a board member on the Committee of Sponsoring Organizations of the Treadway Commission (COSO). These experiences provide unique perspectives about the integration of auditing concepts in real-world settings.

Our purpose is to integrate the most important concepts of auditing in a logical manner to assist students in understanding audit decision making and evidence accumulation in today’s complex, global auditing environment. For example, the risk assessment standards issued by the International Auditing and Assurance Standards Board are integrated into all of the planning chapters, as well as each chapter dealing with a particular transaction cycle and related accounts. Internal control is related to tests of controls and substantive tests of transactions that are performed in an audit of financial statements. Tests of controls and substantive tests of transactions are, in turn, related to the tests of details of financial statement balances for the area. Audit sampling is applied to the evaluation of audit evidence rather than treated as a separate topic. Risk assessment, technology, fraud, and auditing of internal control issues are integrated throughout the chapters. Similarly, developments related to international auditing and issues affecting auditing in a global environment are described throughout the book, with specific examples of how these can be applied to the Arab world.
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KEY FEATURES IN THE ARAB WORLD EDITION

New to the Arab World Edition

This new edition includes many Arab world-specific features that will enable students to connect auditing theory with real Arab world companies and examples that they can relate to:

- New opening case studies from the Arab world that enable students to see how material in the chapter is used in real-life auditing situations.
- A list at the beginning of every chapter of the International Standards on Auditing, related to issues discussed in the chapter and to the audit process and its application in the Arab region.
- Examples from leading Arab and international companies such as Nuqul, Orascom, Media Production Company, Xerox, Zarooni, Mizin, Agility, Istithmar World, Dubai Islamic Bank, Etisalat, Microsoft, Apple, Hawkama Organization, Anwal/Omar Afendi, Linkdottnet, and many others.
- Over 100 international, pan-Arab, and local examples, problems, and case studies featuring real data from the Arab world.
- Integrated Auditing examples providing students with cultural and social insights.
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Emphasis on International and Arab World Issues

The Arab World Edition contains integrated coverage of developments related to international standards on auditing and emphasizes issues affecting audits of multi-national entities. Examples are provided throughout the book of how international standards on auditing have been applied by companies in many Arab world countries, showing the specific culture and economic environment in this important part of the world. Chapter 1 introduces the importance of considering international standards on auditing developments, followed by discussion in Chapter 2 about the role of the International Auditing and Assurance Standards Board (IAASB) in the issuance of international auditing standards. Chapter 2 also discusses Islamic accounting standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB). Chapter 3 highlights implications for auditor reports on companies reporting under International Financial Reporting Standards (IFRS) and describes the SEC’s current roadmap proposal for embracing the use of IFRS for financial reporting by U.S. public companies. Several chapters throughout the book include text or mid-chapter vignette coverage of international issues and their application in the Arab world. International and Arab world issues are also addressed in homework problems, including internet problems.

ACL Problems

CPA firms are increasingly using audit software to perform audit testing including tests for fraud. We have included selected problems using ACL in several chapters in the text. These problems are related to the topic of the chapter so that students can see how audit software is used to perform specific types of audit tests. Additional guidance for students on the use of ACL is included both on the text website and as an appendix to the text. The educational version of ACL software is included with every new copy of this edition.

Coverage of the Sarbanes–Oxley Act and Section 404 Reporting

The requirements of the Sarbanes–Oxley Act, including Section 404 and PCAOB Auditing Standard 5, are integrated throughout the text. We provide extensive coverage of internal controls to help provide students with the understanding of controls necessary to perform a 404 audit, as well as meet the requirements of the risk assessment standards. Although the adherence to the Sarbanes–Oxley Act is required only in the U.S., this topic is important for students studying principles of auditing in the Arab world as many Capital Market Authorities in those countries are currently taking the necessary steps to establish a model of the PCAOB to assess the quality of the audit provided for listed companies in those countries.

Arabian Hardware Annual Report

The annual report for the Arabian Hardware Company is included as a four-color insert to the text. Financial statements and other information included in the annual report are used in examples throughout the text to illustrate chapter concepts. The annual report also includes management’s report on internal control required by Section 404 and the auditor’s report consistent with PCAOB Auditing Standard No. 5.

The text is divided into six parts. The chapters are relatively brief and designed to be easily read and comprehended by students.

Part 1, The Auditing Profession (Chapters 1–5) The book begins with an opening vignette, featuring the Enron fraud, to help students begin to see the connection between recent frauds and the new responsibilities for auditing internal control and other requirements of the Sarbanes–Oxley Act. Chapter 1 introduces key provisions of the Act, including the creation of the PCAOB and Section 404 internal control reporting requirements. Chapter 2 covers the CPA profession, with particular emphasis on the standards setting responsibilities of the PCAOB and how these responsibilities differ from those of the Auditing Standards Board (ASB) of the AICPA. This chapter also introduces the International Auditing and Assurance Standards Board (IAASB) with application in the Arab world. Chapter 3 provides a detailed discussion of audit reports, including a separate section on the report on internal control over financial reporting for a public company. The chapter also emphasizes conditions affecting the type of report the auditor must issue and the type of audit report applicable to each condition under varying levels of materiality. Chapter 4 investigates auditors’ legal liability. Chapter 5 ends this part with an explanation of ethical dilemmas, professional ethics, independence, and the IFAC Code of Ethics for Professional Accountants.

Part 2, The Audit Process (Chapters 6–13) The first two of these chapters deal with auditor and management responsibilities, audit objectives, general concepts of evidence accumulation, and audit documentation, including the management assertions and evidence concepts in the risk assessment standards. Chapter 8 deals with planning the engagement, including understanding the company’s business and its industry as part of risk assessment procedures, and using analytical procedures as an audit tool. Chapter 9 introduces materiality and risk and how the auditor responds to risks of significant misstatement with further audit procedures. Chapter 10 shows how effective internal controls can reduce planned audit evidence in the audit of financial statements. Most of the chapter describes how auditors integrate evidence related to understanding, testing, and assessing internal control to provide a basis for their assessment of control risk in the financial statement audit. Fraud auditing is the focus of Chapter 11 and describes the auditor’s responsibility for assessing fraud risk and detecting fraud. The chapter also includes specific examples of fraud and discusses warning signs and procedures to detect fraud. Chapter 12 addresses the
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Gagan Kukreja, Ahlia University, Bahrain
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Gagan Kukreja, Ahlia University, Bahrain
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Mohamed Hegazy
Things Aren’t Always As They Appear

The Rafedeen Trading Company has been in operation for five years and has always presented strong financial positions and good results of performance. The same auditing firm has performed the audit since the inception of the company and has become very familiar with the company, its operations, and its management.

In 2011, the auditing firm decided, based on the risk assessment, to send a total of 100 positive confirmations to selected companies listed as accounts receivable on the statement of financial position. The senior auditor was put in charge of mailing and following up on the confirmations. After three weeks, busy season was now in full swing and only 30 of the confirmations had been received. The senior was very busy with other work and grumbled to herself, “What a pain, no one ever returns these things . . . and if they do, they are filled out incorrectly! I don’t have time for all of this follow up.”

The senior enlisted the help of the staff auditor on the engagement, who assisted with the follow up of confirmations. The staff auditor didn’t really have a good understanding of the process and did not have much supervision because the senior was so busy. As the weeks rolled on, the staff auditor realized that there were a few confirmations that were just never going to come back and—figuring they were immaterial amounts—she made a note about the forty missing confirmations and marked the workpaper as complete. The other testing areas proceeded normally, and none of the reviewers noticed the note about the missing A/R confirmations on the workpaper. Rafedeen Trading Company showed positive results as usual and the auditing firm issued an unmodified opinion.

Three months later, Rafedeen Trading Company found itself facing liquidity problems and began looking frantically for outside financing. Owners of the company wondered how they had ended up in this situation, considering the results they had showed at year-end. The CEO personally looked into the financial results and through intense questioning found that the Controller and the CFO had conspired to artificially inflate the results of the company by creating fictitious accounts receivable from fictitious companies which were written off after year-end by credit memos. Both the Controller and CFO were fired immediately and the CEO went after the auditing firm next.

Was there something else the auditing firm could have done to detect this fraud during the audit? Granted, fraud committed with collusion between management can be hard to detect, but surely there must have been something else the auditing firm could have done, right?
In the preceding two chapters, we examined tests of controls and substantive tests of transactions for the sales and collection cycle. Both types of tests are part of phase II of the audit process. We now move to phase III and turn our attention to substantive analytical procedures and tests of details of balances for the sales and collection cycle.

This chapter shows that it is essential for auditors to select the appropriate evidence to verify the account balances in the sales and collection cycle, after considering tolerable misstatement, performing risk assessment procedures to assess inherent and control risks, and performing tests of controls and substantive tests of transactions. This chapter examines designing substantive analytical procedures and tests of details of balances for the two key balance sheet accounts in the cycle: accounts receivable and the allowance for uncollectible accounts.

### Relevant International Standards on Auditing

- **ISA 200**: Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing
- **ISA 220**: Quality Control for an Audit of Financial Statements
- **ISA 230**: Audit Documentation
- **ISA 240**: The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements
- **ISA 300**: Planning an Audit of Financial Statements
- **ISA 315**: Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment
- **ISA 320**: Materiality in Planning and Performing an Audit
- **ISA 405**: Evaluation of Misstatements Identified during the Audit
- **ISA 500**: Audit Evidence
- **ISA 505**: External Confirmations
- **ISA 510**: Analytical Procedures
- **ISA 520**: Audit Sampling
- **ISA 540**: Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures

### Methodology for Designing Tests of Details of Balances for Accounts Receivable

**Objective 16-1**

Describe the methodology for designing tests of details of balances using the audit risk model.

Figure 16-1 shows the methodology auditors follow in designing the appropriate tests of details of balances for accounts receivable. The methodology shown in Figure 16-1 relates directly to the evidence planning worksheet first introduced in Chapter 9. The worksheet was partially completed for materiality and risk considerations (part of phase I) and for tests of controls and substantive tests of transactions in Chapter 15 (phase II). We will continue to complete the worksheet as we proceed through phase III in this chapter. For now, you might want to look at the example of a completed worksheet in Figure 16-7 to see what the completed worksheet looks like, to provide you an overview of the focus of this chapter.

The appropriate evidence to be obtained from tests of details of balances must be decided on an objective-by-objective basis. Because several interactions affect the need for evidence from tests of details of balances, this audit decision can be complex. For example, the auditor must evaluate the potential for fraud and also consider inherent risk, which may vary by objective, as well as the results of tests of controls and the related control risk assessment, which also may vary by objective. The auditor must also consider the results of substantive tests of sales and cash receipts.

In designing tests of details of balances for accounts receivable, auditors must satisfy each of the eight balance-related audit objectives discussed in Chapter 6. These eight general objectives are the same for all accounts. Specifically applied to accounts receivable, they are called accounts receivable balance-related audit objectives and are as follows:

1. Accounts receivable in the aged trial balance agree with related master file amounts, and the total is correctly added and agrees with the general ledger. (Detail tie-in)
2. Recorded accounts receivable exist. (Existence)
3. Existing accounts receivable are included. (Completeness)
4. Accounts receivable are accurate. (Accuracy)
5. Accounts receivable are correctly classified. (Classification)
6. Cutoff for accounts receivable is correct. (Cutoff)
7. Accounts receivable is stated at realizable value. (Realizable value)
8. The client has rights to accounts receivable. (Rights)

The columns in the evidence planning worksheet in Figure 16-7 include the balance-related audit objectives. The auditor uses the factors in the rows to aid in assessing planned detection risk for accounts receivable, by objective. The following overview explains the methodology for designing tests of details of balances for accounts receivable.

**Accounts Receivable—Balance-Related Audit Objectives**

The seven specific audit objectives used by the auditor to decide the appropriate audit evidence for accounts receivable are as follows:

1. **Detail tie-in**
2. **Recorded accounts receivable exist. (Existence)**
3. **Existing accounts receivable are included. (Completeness)**
4. **Accounts receivable are accurate. (Accuracy)**
5. **Accounts receivable are correctly classified. (Classification)**
6. **Cutoff for accounts receivable is correct. (Cutoff)**
7. **Accounts receivable is stated at realizable value. (Realizable value)**
8. **The client has rights to accounts receivable. (Rights)**

*Detail tie-in is included as the first objective here, compared with being objective 6 in Chapter 6, because tests for detail tie-in are normally done first.*
This chapter shows that it is essential for auditors to select the appropriate evidence to verify the account balances in the sales and collection cycle, after considering tolerable misstatement, performing risk assessment procedures to assess inherent and control risks, and performing tests of controls and substantive tests of transactions. This chapter examines designing substantive analytical procedures and tests of details of balances for the two key balance sheet accounts in the cycle: accounts receivable and the allowance for uncollectible accounts.

**Figure 16-1** shows the methodology auditors follow in designing the appropriate tests of details of balances for accounts receivable. The methodology shown in Figure 16-1 relates directly to the evidence planning worksheet first introduced in Chapter 9. The worksheet was partially completed for materiality and risk considerations (part of phase I) and for tests of controls and substantive tests of transactions in Chapter 15 (phase II). We will continue to complete the worksheet as we proceed through phase III in this chapter. For now, you might want to look at the example of a completed worksheet in Figure 16-7 to see what the completed worksheet looks like, to provide you an overview of the focus of this chapter.

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The following overview explains the methodology for designing tests of details of balances for accounts receivable.

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1. **Detail tie-in** is included as the first objective here, compared with being objective 6 in Chapter 6, because tests for detail tie-in are normally done first.
Identify Client Business Risks Affecting Accounts Receivable (Phase I)

Tests of accounts receivable are based on the auditor’s risk assessment procedures that provide an understanding of the client’s business and industry, discussed in Chapter 8. As part of this understanding, the auditor studies the client’s industry and external environment and evaluates management objectives and business processes to identify significant client business risks that could affect the financial statements, including accounts receivable. As part of gaining this understanding, the auditor also performs preliminary analytical procedures that may indicate increased risk of misstatements in accounts receivable.

Client business risks affecting accounts receivable are considered in the auditor’s evaluation of inherent risk and planned evidence for accounts receivable. For example, as a result of adverse changes in the industry’s economic environment, the auditor may increase inherent risk for net realizable value of accounts receivable.

Set Tolerable Misstatement and Assess Inherent Risk (Phase I)

As studied in Chapter 9, the auditor first decides the preliminary judgment about materiality for the entire financial statements, and then allocates the preliminary judgment amount to each significant balance sheet account, including accounts receivable. This allocation is called setting tolerable misstatement. Accounts receivable is typically one of the most material accounts in the financial statements for companies that sell on credit. For even small accounts receivable balances, the transactions in the sales and collection cycle affect the balance in accounts receivable because almost certain to be highly significant.

Auditors assess inherent risk for each objective for an account such as accounts receivable, considering client business risk and the nature of the client and industry. Auditing standards indicate that auditors should normally identify the likelihood of fraud risk for revenue recognition. This likely affects the auditor’s assessment of inherent risk for the following objectives: existence, sales cutoff, and sales returns and allowances cutoff. It is common for clients to misstate cutoff either by error or through fraud. It is also common for clients to unintentionally or fraudulently misstate the allowance for uncollectible accounts (realizable value) because of the difficulty of the judgments to determine the correct value.

Assess Control Risk for the Sales and Collection Cycle (Phase I)

Internal controls over sales and cash receipts and the related accounts receivable are at least reasonably effective for most companies because management is concerned with keeping accurate records to maintain good relations with customers. Auditors are especially concerned with three aspects of internal controls:

1. Controls that prevent or detect embezzlements
2. Controls over cutoff
3. Controls related to the allowance for uncollectible accounts

The auditor must relate control risk for transaction-related audit objectives to balance-related audit objectives in deciding planned detection risk and planned evidence for tests of details of balances. For the most part, this relationship is straightforward. Figure 16-2 shows the relationship for the two primary classes of transactions in the sales and collection cycle. For example, assume the auditor concluded that control risk for both sales and cash receipts transactions is low for the accuracy transactions-related audit objective. The auditor can therefore conclude that controls for the accuracy balance-related audit objective for accounts receivable are effective because the only transactions that affect accounts receivable are sales and cash receipts. Of course, if sales returns and allowances and write-offs of uncollectible accounts receivable are significant, assessed control risk must also be considered for these two classes of transactions.
Identify Client Business Risks Affecting Accounts Receivable (Phase I)

Tests of accounts receivable are based on the auditor’s risk assessment procedures that provide an understanding of the client’s business and industry, discussed in Chapter 8. As part of this understanding, the auditor studies the client’s industry and external environment and evaluates management objectives and business processes to identify significant client business risks that could affect the financial statements, including accounts receivable. As part of gaining this understanding, the auditor also performs preliminary analytical procedures that may indicate increased risk of misstatements in accounts receivable.

Client business risks affecting accounts receivable are considered in the auditor’s evaluation of inherent risk and planned evidence for accounts receivable. For example, as a result of adverse changes in the industry’s economic environment, the auditor may increase inherent risk for net realizable value of accounts receivable.

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### Figure 16-2: Relationships between Transaction-Related Audit Objectives for the Sales and Collection Cycle and Balance-Related Audit Objectives for Accounts Receivable

<table>
<thead>
<tr>
<th>CLASS OF TRANSACTIONS</th>
<th>ACCOUNTS RECEIVABLE BALANCE-RELATED AUDIT OBJECTIVES</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Existence</td>
</tr>
<tr>
<td>Sales</td>
<td>Occurrence</td>
</tr>
<tr>
<td></td>
<td>Completeness</td>
</tr>
<tr>
<td></td>
<td>Accuracy</td>
</tr>
<tr>
<td></td>
<td>Posting and summarization</td>
</tr>
<tr>
<td></td>
<td>Classification</td>
</tr>
<tr>
<td></td>
<td>Timing</td>
</tr>
<tr>
<td>Cash receipts</td>
<td>Occurrence</td>
</tr>
<tr>
<td></td>
<td>Completeness</td>
</tr>
<tr>
<td></td>
<td>Accuracy</td>
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<td>Classification</td>
</tr>
<tr>
<td></td>
<td>Timing</td>
</tr>
</tbody>
</table>

Two aspects of the relationships in Figure 16-2 deserve special mention:

1. For sales, the occurrence transaction-related audit objective affects the existence balance-related audit objective. For cash receipts, however, the occurrence transaction-related audit objective affects the completeness balance-related audit objective. A similar relationship exists for the completeness transaction-related audit objective. The reason for this somewhat surprising conclusion is that an increase in sales increases accounts receivable, but an increase in cash receipts decreases accounts receivable. For example, recording a sale that did not occur violates the occurrence transaction-related audit objective and existence balance-related audit objective (both overstatements). Recording a cash receipt that did not occur violates the occurrence transaction-related audit objective, but it also violates the completeness balance-related audit objective for accounts receivable because a receivable that is still outstanding is no longer included in the records.

2. The realizability and rights for accounts receivable balance-related audit objectives, as well as the presentation and disclosure-related objectives, are not affected by assessed control risk for classes of transactions. To assess control risk below the maximum for these objectives, the auditor must identify and test separate controls that support those objectives.

Figure 16-7 includes three rows for assessed control risk: one for sales, one for cash receipts, and one for additional controls related to the accounts receivable balance. The source of each control risk for sales and cash receipts is the control risk matrix assuming that the tests of controls results supported the original assessment. The auditor makes a separate assessment of control risk for objectives that are related only to the accounts receivable balance or to presentation and disclosure audit objectives.

### Design and Perform Tests of Controls and Substantive Tests of Transactions (Phase II)

The results of the tests of controls determine whether assessed control risk for sales and cash receipts needs to be revised. Auditors use the results of the substantive tests of transactions to determine the extent to which planned detection risk is satisfied for each accounts receivable balance-related audit objective. The evidence planning worksheet in Figure 16-7 shows three rows for control risk and two for substantive tests of transactions, one for sales, and the other for cash receipts.

### Design and Perform Analytical Procedures (Phase III)

As discussed in Chapter 8, analytical procedures are often done during three phases of the audit: during planning, when performing detailed tests, and as a part of completing the audit. This chapter covers planning analytical procedures and substantive analytical procedures done when performing detailed tests for accounts in the sales and collection cycle.

Most analytical procedures performed during the detailed testing phase are done after the balance sheet date but before tests of details of balances. It makes little sense to perform extensive analytical procedures before the client has recorded all transactions for the year and finalized the financial statements.

Auditors perform analytical procedures for the entire sales and collection cycle, not just accounts receivable. This is necessary because of the close relationship between income statement and balance sheet accounts. If the auditor identifies possible misstatement in sales or sales returns and allowances using analytical procedures, accounts receivable will likely be the offsetting misstatement.

Table 16-2 presents comparative trial balance information for the sales and collection cycle.

| Objective 16-2 | Design and perform analytical procedures for accounts in the sales and collection cycle. |

| Table 16-2: Comparative Trial Balance Information for the Sales and Collection Cycle |

<table>
<thead>
<tr>
<th></th>
<th>Sales</th>
<th>Cash Receipts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts Receivable</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Costs and Expenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Income</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Although Table 16-1 focuses on the comparison of current year results with previous years, auditors also consider current year results compared to budgets and industry trends. Observe in the ‘possible misstatement’ column how both balance sheet and income statement accounts are affected. For example, when the auditor performs analytical procedures for sales, evidence is being obtained about both sales and accounts receivable.

In addition to the analytical procedures in Table 16-1, auditors should also review accounts receivable for large and unusual amounts, such as large balances, accounts that have been outstanding for a long time, receivables from affiliated companies, officers, directors, and other related parties, and credit balances. To identify these amounts the auditor should review the listing of accounts (aged trial balance) at the balance sheet date to determine which accounts should be investigated further.

To illustrate the use of analytical procedures during the detailed testing phase, Table 16-2 presents comparative trial balance information for the sales and collection cycle information for Arabian Hardware Co. Building on that information, Table 16-3 demonstrates several substantive analytical procedures. The only potential misstatement indicated in these two tables is in the allowance for uncollectible accounts. This is indicated by the ratio of the allowance to accounts receivable, as explained at the bottom of Table 16-3.
Part 3 / APPLICATION OF THE AUDIT PROCESS TO THE SALES AND COLLECTION CYCLE

Chapter 16 / COMPLETING THE TESTS IN THE SALES AND COLLECTION CYCLE

FIGURE 16-2

Relationships between Transaction-Related Audit Objectives for the Sales and Collection Cycle and Balance-Related Audit Objectives for Accounts Receivable

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<td>Occurrence</td>
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<td>X</td>
</tr>
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Most analytical procedures performed during the detailed testing phase are done after the balance sheet date but before tests of details of balances. It makes little sense to perform extensive analytical procedures before the client has recorded all transactions for the year and finalized the financial statements.

Auditors perform analytical procedures for the entire sales and collection cycle, not just accounts receivable. This is necessary because of the close relationship between income statement and balance sheet accounts. If the auditor identifies possible misstatement in sales or cash receipts, and one for additional controls related to the accounts receivable balance.

In addition to the analytical procedures in Table 16-1, auditors should also review accounts receivable for large and unusual amounts, such as large balances, accounts that have been outstanding for a long time, receivables from affiliated companies, officers, directors, and other related parties, and credit balances. To identify these amounts, the auditor should review the listing of accounts (aged trial balance) at the balance sheet date to determine which accounts should be investigated further.

To illustrate the use of analytical procedures during the detailed testing phase, Table 16-2 presents comparative trial balance information for the sales and collection cycle information for Arabian Hardware Co. Building on that information, Table 16-3 demonstrates several substantive analytical procedures. The only potential misstatement indicated in these two tables is in the allowance for uncollectible accounts. This is indicated by the ratio of the allowance to accounts receivable, as explained at the bottom of Table 16-3.

Table 16-2 presents examples of ratios and comparisons for the sales and collection cycle and potential misstatements that analytical procedures may uncover. Although Table 16-1 focuses on the comparison of current year results with previous years, auditors also consider current year results compared to budgets and industry trends. Observe in the ‘possible misstatement’ column how both balance sheet and income statement accounts are affected. For example, when the auditor performs analytical procedures for sales, evidence is being obtained about both sales and accounts receivable.

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The auditor's conclusions about substantive analytical procedures for the sales and collection cycle are incorporated in the evidence planning worksheet in Figure 16-7. These conclusions include the nature of details of accounts receivable that have not been performed for. The auditor's conclusions should be critically evaluated to determine whether they adequately explain the unusual fluctuations and whether they are supported by corroborating evidence.

### TABLE 16-1 Analytical Procedures for the Sales and Collection Cycle

<table>
<thead>
<tr>
<th>Analytical Procedure</th>
<th>Possible Misstatement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compare gross margin percentage with previous years (by product line).</td>
<td>Overstatement or understatement of sales revenue and accounts receivable.</td>
</tr>
<tr>
<td>Compare sales by month (by product line) over time.</td>
<td>Overstatement or understatement of sales revenue and accounts receivable.</td>
</tr>
<tr>
<td>Compare sales returns and allowances as a percentage of gross sales with previous years (by product line).</td>
<td>Overstatement or understatement of sales returns and allowances and accounts receivable.</td>
</tr>
<tr>
<td>Compare individual customer balances over a stated amount with previous years.</td>
<td>Misstated accounts receivable and related income statement accounts.</td>
</tr>
<tr>
<td>Compare bad debt expense as a percentage of gross sales with previous years.</td>
<td>Uncollectible accounts receivable that have not been provided for.</td>
</tr>
<tr>
<td>Compare number of days that accounts receivable are outstanding with previous years and related turnover of accounts receivable.</td>
<td>Overstatement or understatement of allowance for uncollectible accounts and bad debt expense; also may indicate fictitious accounts receivable.</td>
</tr>
<tr>
<td>Compare aging categories as a percentage of accounts receivable with previous years.</td>
<td>Overstatement or understatement of allowance for uncollectible accounts and bad debt expense.</td>
</tr>
<tr>
<td>Compare allowance for uncollectible accounts as a percentage of accounts receivable with previous years.</td>
<td>Overstatement or understatement of allowance for uncollectible accounts and bad debt expense.</td>
</tr>
<tr>
<td>Compare write-off of uncollectible accounts as a percentage of total accounts receivable with previous years.</td>
<td>Overstatement or understatement of allowance for uncollectible accounts and bad debt expense.</td>
</tr>
</tbody>
</table>

### TABLE 16-2 Comparative Information for Arabian Hardware Co.—Sales and Collection Cycle

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
<th>Percent Change</th>
<th>Percent Change</th>
<th>Percent Change</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>31/12/2012</td>
<td>31/12/2011</td>
<td>31/12/2010</td>
<td>31/12/2012</td>
</tr>
<tr>
<td>Sales</td>
<td>US$144,328</td>
<td>9.0%</td>
<td>US$132,421</td>
<td>7.0%</td>
</tr>
<tr>
<td>Sales returns and allowances</td>
<td>1,242</td>
<td>3.9%</td>
<td>1,195</td>
<td>13.6%</td>
</tr>
<tr>
<td>Gross margin</td>
<td>39,845</td>
<td>9.6%</td>
<td>36,350</td>
<td>7.0%</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>20,197</td>
<td>15.3%</td>
<td>17,521</td>
<td>3.3%</td>
</tr>
<tr>
<td>Allowance for uncollectible accounts</td>
<td>1,240</td>
<td>5.4%</td>
<td>1,311</td>
<td>21.5%</td>
</tr>
<tr>
<td>Bad debt expense</td>
<td>3,323</td>
<td>(2.1)%</td>
<td>3,394</td>
<td>7.3%</td>
</tr>
<tr>
<td>Total current assets</td>
<td>51,027</td>
<td>2.3%</td>
<td>49,895</td>
<td>1.5%</td>
</tr>
<tr>
<td>Total assets</td>
<td>61,367</td>
<td>0.9%</td>
<td>60,791</td>
<td>1.8%</td>
</tr>
<tr>
<td>Net earnings before taxes</td>
<td>4,681</td>
<td>21.9%</td>
<td>4,659</td>
<td>39.0%</td>
</tr>
<tr>
<td>Number of accounts receivable</td>
<td>358</td>
<td>16.7%</td>
<td>321</td>
<td>5.7%</td>
</tr>
<tr>
<td>Number of accounts receivable with balance over US$10,000</td>
<td>37</td>
<td>15.6%</td>
<td>32</td>
<td>6.7%</td>
</tr>
</tbody>
</table>

When analytical procedures in the sales and collection cycle uncover unusual fluctuations, the auditor should make additional inquiries of management. Management's responses should be critically evaluated to determine whether they adequately explain the unusual fluctuations and whether they are supported by corroborating evidence.

### TABLE 16-3 Analytical Procedures for Arabian Hardware Co.—Sales and Collection Cycle

<table>
<thead>
<tr>
<th>Year</th>
<th>Gross margin/net sales</th>
<th>Sales returns and allowances/gross sales</th>
<th>Bad debt expense/net sales</th>
<th>Allowance for uncollectible accounts/ accounts receivable</th>
<th>Number of days receivables outstanding*</th>
<th>Net accounts receivable/total current assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>31/12/2010</td>
<td>27.65%</td>
<td>0.9%</td>
<td>2.3%</td>
<td>6.1%</td>
<td>48.0%</td>
<td>37.2%</td>
</tr>
<tr>
<td>31/12/2011</td>
<td>27.70%</td>
<td>0.9%</td>
<td>2.3%</td>
<td>5.7%</td>
<td>47.6%</td>
<td>32.5%</td>
</tr>
<tr>
<td>31/12/2012</td>
<td>27.68%</td>
<td>0.9%</td>
<td>2.3%</td>
<td>6.4%</td>
<td>49.3%</td>
<td>32.3%</td>
</tr>
</tbody>
</table>

*Based on year-end accounts receivable only.

Even though auditors emphasize balance sheet accounts in tests of details of balances, they are not ignoring income statement accounts because the income statement accounts are tested as a by-product of the balance sheet tests. For example, if the auditor confirms accounts receivable balances and finds overstated caused by mistakes in billing customers, then both accounts receivable and sales are overstated.

### DESIGNING TESTS OF DETAILS OF BALANCES

#### OBJECTIVE 16-3

Design and perform tests of details of balances for accounts receivable.
The auditor’s conclusions about substantive analytical procedures for the sales and collection cycle are incorporated in the evidence planning worksheet in Figure 16-7 (p. 559) in the third row from the bottom. Because analytical procedures are substantive tests, they reduce the extent to which the auditor needs to perform detailed tests of balances, if the analytical procedure results are favorable.

### TABLE 16-1 Analytical Procedures for the Sales and Collection Cycle

<table>
<thead>
<tr>
<th>Analytical Procedure</th>
<th>Possible Misstatement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compare gross margin percentage with previous years (by product line).</td>
<td>Overstatement or understatement of sales and accounts receivable.</td>
</tr>
<tr>
<td>Compare sales by month (by product line) over time.</td>
<td>Overstatement or understatement of sales and accounts receivable.</td>
</tr>
<tr>
<td>Compare sales returns and allowances as a percentage of gross sales with previous years (by product line).</td>
<td>Overstatement or understatement of sales returns and allowances and accounts receivable.</td>
</tr>
<tr>
<td>Compare individual customer balances over a stated amount with previous years.</td>
<td>Misstatements in accounts receivable and related income statement accounts.</td>
</tr>
<tr>
<td>Compare bad debt expense as a percentage of gross sales with previous years.</td>
<td>Uncollectible accounts receivable that have not been provided for.</td>
</tr>
<tr>
<td>Compare number of days that accounts receivable are outstanding with previous years and related turnover of accounts receivable.</td>
<td>Overstatement or understatement of allowance for uncollectible accounts and bad debt expense; also may indicate fictitious accounts receivable.</td>
</tr>
<tr>
<td>Compare aging categories as a percentage of accounts receivable with previous years.</td>
<td>Overstatement or understatement of allowance for uncollectible accounts and bad debt expense.</td>
</tr>
<tr>
<td>Compare allowance for uncollectible accounts as a percentage of accounts receivable with previous years.</td>
<td>Overstatement or understatement of allowance for uncollectible accounts and bad debt expense.</td>
</tr>
<tr>
<td>Compare write-off of uncollectible accounts as a percentage of total accounts receivable with previous years.</td>
<td>Overstatement or understatement of allowance for uncollectible accounts and bad debt expense.</td>
</tr>
</tbody>
</table>

### TABLE 16-2 Comparative Information for Arabian Hardware Co.—Sales and Collection Cycle

<table>
<thead>
<tr>
<th>Amount</th>
<th>31/12/2012</th>
<th>Percent Change</th>
<th>31/12/2011</th>
<th>Percent Change</th>
<th>31/12/2010</th>
<th>Percent Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales (in Thousands)</td>
<td>$44,328</td>
<td>9.0%</td>
<td>$31,241</td>
<td>7.0%</td>
<td>$29,123</td>
<td>7.3%</td>
</tr>
<tr>
<td>Sales returns and allowances</td>
<td>1,242</td>
<td>3.9%</td>
<td>1,195</td>
<td>3.6%</td>
<td>1,052</td>
<td>3.3%</td>
</tr>
<tr>
<td>Gross margin</td>
<td>39,845</td>
<td>9.6%</td>
<td>36,200</td>
<td>7.0%</td>
<td>33,961</td>
<td>7.3%</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>20,197</td>
<td>15.3%</td>
<td>17,521</td>
<td>3.3%</td>
<td>16,961</td>
<td>2.3%</td>
</tr>
<tr>
<td>Allowance for uncollectible accounts</td>
<td>1,240</td>
<td>5.4%</td>
<td>1,131</td>
<td>4.1%</td>
<td>1,079</td>
<td>3.8%</td>
</tr>
<tr>
<td>Bad debt expense</td>
<td>3,232</td>
<td>(2.1)%</td>
<td>3,394</td>
<td>7.3%</td>
<td>3,162</td>
<td>2.3%</td>
</tr>
<tr>
<td>Total current assets</td>
<td>51,227</td>
<td>2.3%</td>
<td>49,096</td>
<td>4.8%</td>
<td>47,051</td>
<td>5.4%</td>
</tr>
<tr>
<td>Total assets</td>
<td>61,367</td>
<td>0.9%</td>
<td>60,791</td>
<td>1.8%</td>
<td>59,196</td>
<td>2.1%</td>
</tr>
<tr>
<td>Net earnings before taxes</td>
<td>5,481</td>
<td>21.9%</td>
<td>4,659</td>
<td>39.9%</td>
<td>3,351</td>
<td>39.5%</td>
</tr>
<tr>
<td>Number of accounts receivable</td>
<td>258</td>
<td>15.7%</td>
<td>221</td>
<td>5.7%</td>
<td>209</td>
<td>2.5%</td>
</tr>
<tr>
<td>Number of accounts receivable with balance over US$10,000</td>
<td>37</td>
<td>15.6%</td>
<td>32</td>
<td>6.7%</td>
<td>30</td>
<td>6.0%</td>
</tr>
</tbody>
</table>

---

When analytical procedures in the sales and collection cycle uncover unusual fluctuations, the auditor should make additional inquiries of management. Management’s responses should be critically evaluated to determine whether they adequately explain the unusual fluctuations and whether they are supported by corroborating evidence.

### Design and Perform Tests of Details of Accounts Receivable Balance (Phase III)

The appropriate tests of details of balances depend on the factors listed in the evidence planning worksheet in Figure 16-7. Planned detection risk for each accounts receivable balance-related audit objective is shown in the second row from the bottom in Figure 16-7. It is a subjective decision made by auditors after they have combined the conclusions reached about each of the factors listed above that row.

The task of combining the factors that determine planned detection risk is complex because the measurement for each factor is imprecise and the appropriate weight given to each factor is highly subjective. Conversely, the relationship between each factor and planned detection risk is well established. For example, auditors know that a high inherent risk or control risk decreases planned detection risk and increases planned substantive tests, whereas good results of substantive tests of transactions increase planned detection risk and decrease other planned substantive tests.

The bottom row in Figure 16-7 shows the planned audit evidence for tests of details of balances for accounts receivable, by objective. As we’ve discussed, planned audit evidence is the inverse of planned detection risk. After deciding whether planned audit evidence for a given objective is high, medium, or low, the auditor must then decide on the appropriate audit procedures, sample size, items to select, and timing.

For the remainder of this chapter, we will discuss how auditors decide on the specific audit procedures and their timing for auditing accounts receivable. In Chapter 17, we’ll address sample size and selecting items from the population for testing.

### DESIGNING TESTS OF DETAILS OF BALANCES

Even though auditors emphasize balance sheet accounts in tests of details of balances, they are not ignoring income statement accounts because the income statement accounts are tested as a by-product of the balance sheet tests. For example, if the auditor confirms accounts receivable balances and finds overstatements caused by mistakes in billing customers, then both accounts receivable and sales are overstated.

<table>
<thead>
<tr>
<th>OBJECTIVE 16-3 Design and perform tests of details of balances for accounts receivable.</th>
<th>31/12/2012</th>
<th>31/12/2011</th>
<th>31/12/2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross margin/net sales</td>
<td>27.85%</td>
<td>27.70%</td>
<td>27.68%</td>
</tr>
<tr>
<td>Sales returns and allowances/gross sales</td>
<td>0.9%</td>
<td>0.9%</td>
<td>0.9%</td>
</tr>
<tr>
<td>Bad debt expense/net sales</td>
<td>2.3%</td>
<td>2.6%</td>
<td>2.6%</td>
</tr>
<tr>
<td>Allowance for uncollectible accounts/ accounts receivable</td>
<td>6.1%</td>
<td>7.5%</td>
<td>6.4%</td>
</tr>
<tr>
<td>Number of days receivables outstanding</td>
<td>48.09</td>
<td>47.96</td>
<td>49.32</td>
</tr>
<tr>
<td>Net accounts receivable/total current assets</td>
<td>37.2%</td>
<td>32.5%</td>
<td>32.3%</td>
</tr>
</tbody>
</table>

*Based on year-end accounts receivable only.*

Current Allowance as a percentage of accounts receivable has declined from 6% to 4%. Number of days receivables outstanding and economic conditions do not justify this change. Potential misstatement is approximately US$16,000 (US$20,157,000 / 1,010 – 1,016).
Confirmation of accounts receivable is the most important test of details of accounts receivable. We will discuss confirmation briefly as we study the appropriate tests for each of the balance-related audit objectives. We'll examine it in more detail later in this chapter.

For our discussion of tests of details of balances for accounts receivable, we will focus on balance-related audit objectives. We will also assume two things:
1. Auditors have completed an evidence planning worksheet similar to the one in Figure 16-7.
2. They have decided planned detection risk for tests of details for each balance-related audit objective.

The audit procedures selected and their sample size will depend heavily on whether planned evidence for a given objective is low, medium, or high.

**Accounts Receivable Are Correctly Added and Agree with the Master File and the General Ledger**

Most tests of accounts receivable and the allowance for uncollectible accounts are based on the aged trial balance. An **aged trial balance** lists the balances in the accounts receivable master file at the balance sheet date, including individual customer balances outstanding and a breakdown of each balance by the time passed between the date of sale and the balance sheet date. Figure 16-3 illustrates a typical aged trial balance, based on the Arabian Hardware example.

Ordinarily, auditors test the information on the aged trial balance for detail tie-in before any other tests to verify that the population being tested agrees with the general ledger and accounts receivable master file. The total column and the columns depicting the aging must be test footed and the total on the trial balance compared with the ledger and accounts receivable master file. The total column and the columns depicting the aging must be test footed and the total on the trial balance compared with the ledger and accounts receivable master file. In addition, auditors should trace a sample of individual balances to supporting documents such as duplicate sales invoices to verify the customer's name, balance, and proper aging. The extent of the testing for detail tie-in depends on the number of accounts involved, the degree to which the master file has been tested as a part of tests of controls and substantive tests of transactions, and the extent to which the schedule has been verified by an internal auditor or other independent person before it is given to the auditor. Auditors often use audit software to foot and cross-foot the aged trial balance and to recalculate the aging.

**Recorded Accounts Receivable Exist**

Confirmation of customers' balances is the most important test of details of balances for determining the existence of recorded accounts receivable. When customers do not respond to confirmations, auditors also examine supporting documents to verify the shipment of goods and evidence of subsequent cash receipts to determine whether the accounts were collected. Normally, auditors do not examine shipping documents or evidence of subsequent cash receipts for any account in the sample that is confirmed, but they may use these documents extensively as alternative evidence for nonresponses.

**Existing Accounts Receivable are Included**

It is difficult for auditors to test for account balances omitted from the aged trial balance except by relying on the self-balancing nature of the accounts receivable master file. For example, if the client accidentally excluded an account receivable from the trial balance, the only likely way it will be discovered is for the auditor to foot the accounts receivable trial balance and reconcile the balance with the control account in the general ledger.

If all sales to a customer are omitted from the sales journal, the understatement of accounts receivable is almost impossible to uncover by tests of details of balances. For example, auditors rarely send accounts receivable confirmations to customers with zero balances, in part because research shows that customers are unlikely to respond to requests that indicate their balances are understated. In addition, unrecorded sales to a new customer are difficult to identify for confirmation because the customer is not included in the accounts receivable master file. The understatement of sales and accounts receivable is best uncovered by substantive tests of transactions for shipments made but not recorded (completeness objective for tests of sales transactions) and by analytical procedures.

**Accounts Receivable are Accurate**

Confirmation of accounts selected from the trial balance is the most common test of details of balances for the accuracy of accounts receivable. When customers do not respond to confirmation requests, auditors examine supporting documents in the same way as described for the existence objective. Auditors perform tests of the debits and credits to individual customers' balances by examining supporting documentation for shipments and cash receipts.

**Accounts Receivable are Properly Classified**

Normally, auditors can evaluate the classification of accounts receivable relatively easily, by reviewing the aged trial balance for material receivables from affiliates, officers, directors, or other related parties. Auditors should verify that notes receivable or accounts that should be classified as noncurrent assets are separated from regular accounts, and significant credit balances in accounts receivable are reclassified as accounts payable.

There is a close relationship between the classification balance-related objective and the related classification and understandability presentation and disclosure objective. To satisfy the classification balance-related audit objective, the auditor must determine
Confirmation of accounts receivable is the most important test of details of accounts receivable. We will discuss confirmation briefly as we study the appropriate tests for each of the balance-related audit objectives. We’ll examine it in more detail later in this chapter.

For our discussion of tests of details of balances for accounts receivable, we will focus on balance-related audit objectives. We will also assume two things:

1. Auditors have completed an evidence planning worksheet similar to the one in Figure 16-7.
2. They have decided planned detection risk for tests of each balance-related audit objective.

The audit procedures selected and their sample size will depend heavily on whether planned evidence for a given objective is low, medium, or high.

**Accounts Receivable Are Correctly Added and Agree with the Master File and the General Ledger**

Most tests of accounts receivable and the allowance for uncollectible accounts are based on the aged trial balance. An **aged trial balance** lists the balances in the accounts receivable master file at the balance sheet date, including individual customer balances outstanding and a breakdown of each balance by the time passed between the date of sale and the balance sheet date. Figure 16-3 illustrates a typical aged trial balance, based on the Arabian Hardware example.

Ordinarily, auditors test the information on the aged trial balance for detail tie-in before any other tests to verify that the population being tested agrees with the general ledger and accounts receivable master file. The total column and the columns depicting the aging must be test footed and the total on the trial balance compared with the general ledger. In addition, auditors should trace a sample of individual balances to supporting documents such as duplicate sales invoices to verify the customer’s name, balance, and proper aging. The extent of the testing for detail tie-in depends on the number of accounts involved, the degree to which the master file has been tested as a part of tests of controls and substantive tests of transactions, and the extent to which the schedule has been verified by an internal auditor or other independent person before it is given to the auditor. Auditors often use audit software to foot and cross-foot the aged trial balance and to recalculate the aging.

**Figure 16-3** Aged Trial Balance for Arabian Hardware Co.

<table>
<thead>
<tr>
<th>Account Number</th>
<th>Customer</th>
<th>Balance</th>
<th>Aging, Based on Invoice Date</th>
</tr>
</thead>
</table>
| 01010          | Adams Supply              | 146,589 | 0–30  
| 01044          | Argonne, Inc.             | 30,842  | 31–60                        |
| 01100          | Arrowhead Builders        | 210,389 | 61–90                        |
| 01119          | Bakerman Bearings         | 83,526  | 91–120                       |
| 01270          | Brown and Phillips        | 60,000  | over 120                     |
| 01301          | Christopher Plumbing      | 15,789  |                               |

<table>
<thead>
<tr>
<th>Schedule Prepared by</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prepared by Client</td>
<td>5/1/13</td>
</tr>
</tbody>
</table>

**Recorded Accounts Receivable Exist**

Confirmation of customers’ balances is the most important test of details of balances for determining the existence of recorded accounts receivable. When customers do not respond to confirmations, auditors also examine supporting documents to verify the shipment of goods and evidence of subsequent cash receipts to determine whether the accounts were collected. Normally, auditors do not examine shipping documents or evidence of subsequent cash receipts for any account in the sample that is confirmed, but they may use these documents extensively as alternative evidence for nonresponses.

**Existing Accounts Receivable are Included**

It is difficult for auditors to test for account balances omitted from the aged trial balance except by relying on the self-balancing nature of the accounts receivable master file. For example, if the client accidentally excluded an account receivable from the trial balance, the only likely way it will be discovered is for the auditor to note that the accounts receivable trial balance and reconcile the balance with the control account in the general ledger.

If all sales to a customer are omitted from the sales journal, the understatement of accounts receivable is almost impossible to uncover by tests of details of balances. For example, auditors rarely send accounts receivable confirmations to customers with zero balances, in part because research shows that customers are unlikely to respond to requests that indicate their balances are understated. In addition, unrecorded sales to a new customer are difficult to identify for confirmation because that customer is not included in the accounts receivable master file. The understatement of sales and accounts receivable is best uncovered by substantive tests of transactions for shipments made but not recorded (completeness objective for tests of sales transactions) and by analytical procedures.

**Accounts Receivable are Accurate**

Confirmation of accounts selected from the trial balance is the most common test of details of balances for the accuracy of accounts receivable. When customers do not respond to confirmation requests, auditors examine supporting documents in the same way as described for the existence objective. Auditors perform tests of the debts and credits to individual customers’ balances by examining supporting documentation for shipments and cash receipts.

**Accounts Receivable are Properly Classified**

Normally, auditors can evaluate the classification of accounts receivable relatively easily, by reviewing the aged trial balance for material receivables from affiliates, officers, directors, or other related parties. Auditors should verify that notes receivable or accounts that should be classified as noncurrent assets are separated from regular accounts, and significant credit balances in accounts receivable are reclassified as accounts payable.

There is a close relationship between the classification balance-related objective and the related classification and understandability presentation and disclosure objective. To satisfy the classification balance-related audit objective, the auditor must determine...
whether the client has correctly separated different classifications of accounts receivable. For example, the auditor will determine whether receivables from related parties have been documented on the objective for presentation and disclosure, the auditor must make sure that the classifications are properly presented by determining whether related party transactions are correctly shown in the financial statements during the completion phase of the audit.

**Cutoff for Accounts Receivable Is Correct**

Cutoff misstatements exist when current period transactions are recorded in the subsequent period or vice versa. The objective of cutoff tests, regardless of the type of transaction, is to verify whether transactions near the end of the accounting period are recorded in the proper period. The cutoff objective is one of the most important in the cycle because misstatements in cutoff can significantly affect current period income. For example, the intentional or unintentional inclusion of several large, subsequent period sales in the current period—or the exclusion of several current period sales returns and allowances—can materially overstate net earnings.

Cutoff misstatements can occur for sales, sales returns and allowances, and cash receipts. For each one, auditors require a threefold approach to determine the reasonableness of cutoff:

1. Decide on the appropriate criteria for cutoff.
2. Evaluate whether the client has established adequate procedures to ensure a reasonable cutoff.
3. Test whether the cutoff was correct.

**Sales Cutoff**

Most merchandising and manufacturing clients record a sale based on shipment of goods criteria. However, some companies record invoices at the time title passes, which can occur before shipment (as in the case of custom-manufactured goods), at the time of shipment, or subsequent to shipment. For the correct measurement of current period income, the method must be in accordance with International Financial Reporting Standards (IFRS) or local accounting standards and consistently applied.

Faced with declining sales for its traditional product lines, Xerox, a transnational printing equipment and document manufacturers company with offices all over the world including all Arab countries, prematurely recognized revenues to meet market expectations, according to charges filed by the SEC. The SEC stated that Xerox accelerated the recognition of equipment revenue to increase revenues by over US$3 billion and pre-tax earnings by approximately US$1.5 billion over the period 1997 through 2000. The early revenue recognition and other actions to increase earnings were significant, representing 37 percent of reported pre-tax earnings for the fourth quarters of 1997 and 1998. Without these actions to increase earnings, the SEC charged that Xerox would have fallen short of market earnings expectations for almost every reporting period from 1997 through 1999. A primary issue was how Xerox accounted for lease revenue. The revenue in Xerox’s leasing arrangements represented three components: the value of the equipment, servicing over the life of the lease, and financing. The revenue from the equipment was recorded at the beginning of the lease, but revenues from servicing and financing were recognized over the life of the lease contract. According to the SEC complaint, Xerox took a number of actions to shift servicing and financing revenue to the value of the equipment, so that more of the revenue could be recognized immediately.

The SEC alleged that these actions were set by Xerox at the top and ordered six senior executives to pay over US$2 million in penalties and disgorgement of profits from their actions. Without admitting or denying the allegations made in the SEC complaint, Xerox agreed to pay a US$10 million fine, at that time the largest ever for a public company.

**Timing difference**

A reported difference in a confirmation from a debtor that is determined to be a timing difference between the client’s and debtor’s records and therefore not a misstatement.

The most important part of evaluating the client’s method of obtaining a reliable cutoff is to determine the procedures in use. When a client issues prenumbered shipping documents, it is usually a simple matter to evaluate and test cutoff. Moreover, the segregation of duties between the shipping and the billing function also enhances the likelihood of recording transactions in the proper period. However, if shipments are made by company truck, if the shipping records are unnumbered, and if shipping and billing department personnel are not independent of each other, it may be difficult, if not impossible, to be assured of an accurate cutoff.

When the client’s internal controls are adequate, auditors can usually verify the cutoff by obtaining the shipping document number for the last shipment made at the end of the period and comparing this number with current and subsequent period recorded sales. As an illustration, assume the shipping document number for the last shipment in the current period is 1499. All recorded sales before the end of the period should bear a shipping document number preceding number 1490, and no sales recorded and shipped in the subsequent period should have a bill of lading numbered 1498 or lower. An auditor can easily test this by comparing recorded sales with the related shipping documents for the last few days of the current period and the first few days of the subsequent period.

**Sales Returns and Allowances Cutoff**

Accounting standards require that sales returns and allowances be matched with related sales if the amounts are material. For example, if current period shipments are returned in the subsequent period, the sales return should appear in the current period. (The returned goods should be treated as current period inventory.) For most companies, however, sales returns and allowances are recorded in the accounting period in which they occur, under the assumption of approximately equal, offsetting amounts at the beginning and end of each accounting period. This approach is acceptable as long as the amounts are not material. Some companies establish a reserve, similar to the allowance for uncollectible accounts, for the expected amount of returns in the subsequent period.

When the auditor is confident that the client records all sales returns and allowances promptly, the cutoff tests are simple and straightforward. The auditor can examine supporting documentation for a sample of sales returns and allowances recorded during several weeks subsequent to the closing date to determine the date of the original sale. If auditors discover that the amounts recorded in the subsequent period are significantly different from unrecorded returns and allowances at the beginning of the period under audit, they must consider an adjustment. For example, a company may experience an increase in sales returns when it expands internet sales because customers are unable to examine the product before purchase. In addition, if the internal controls for recording sales returns and allowances are evaluated as ineffective, a larger sample is needed to verify cutoff.

**Cash Receipts Cutoff**

For most audits, a proper cash receipts cutoff is less important than either the sales or the sales returns and allowances cutoff because the improper cutoff of cash offsets only the cash and the accounts receivable balances, not earnings. Nevertheless, if the misstatement is material, it can affect the fair presentation of these accounts, especially when cash is a small or negative balance.

It is easy to test for a cash receipts cutoff misstatement (often called holding the cash receipts book open) by tracing recorded cash receipts to subsequent period bank deposits on the bank statement. If a delay of several days exists, that could indicate a cutoff misstatement.

To some degree, auditors may also rely on the confirmation of accounts receivable to uncover cutoff misstatements for sales, sales returns, and cash receipts. However, it is often difficult to distinguish a cutoff misstatement from a normal timing difference due to shipments and payments in transit at year end.
whether the client has correctly separated different classifications of accounts receivable. For example, the auditor will determine whether receivables from related parties have been documented on the objective for presentation and disclosure, the auditor must make sure that the classifications are properly presented by determining whether related party transactions are correctly shown in the financial statements during the completion phase of the audit.

**Cutoff for Accounts Receivable Is Correct**

Cutoff misstatements exist when current period transactions are recorded in the subsequent period or vice versa. The objective of cutoff tests, regardless of the type of transaction, is to verify whether transactions near the end of the accounting period are recorded in the proper period. The cutoff objective is one of the most important in the cycle because misstatements in cutoff can significantly affect current period income. For example, the intentional or unintentional inclusion of several large, subsequent period sales in the current period—or the exclusion of several current period sales returns and allowances—can materially overstate net earnings.

Cutoff misstatements can occur for sales, sales returns and allowances, and cash receipts. For each one, auditors require a threefold approach to determine the reasonableness of cutoff:

1. Decide on the appropriate criteria for cutoff.
2. Evaluate whether the client has established adequate procedures to ensure a reasonable cutoff.
3. Test whether the cutoff was correct.

**Sales Cutoff**

Most merchandising and manufacturing clients record a sale based on shipment of goods criteria. However, some companies record invoices at the time title passes, which can occur before shipment (as in the case of custom-manufactured goods), at the time of shipment, or subsequent to shipment. For the correct measurement of current period income, the method must be in accordance with International Financial Reporting Standards (IFRS) or local accounting standards and consistently applied.

EARLY REVENUE RECOGNITION BOOSTS PROFITS

Faced with declining sales for its traditional product lines, Xerox, a transnational printing company with offices all over the world including all Arab countries, prematurely recognized revenues to meet market expectations, according to charges filed by the SEC. The SEC stated that Xerox accelerated the recognition of equipment revenue to increase revenues by over US$3 billion and pre-tax earnings by approximately US$1.5 billion over the period 1997 through 2000. The early revenue recognition and other actions to increase earnings were significant, representing 37 percent of reported pre-tax earnings for the fourth quarters of 1997 and 1998. Without these actions to increase earnings, the SEC charged that Xerox would have fallen short of market earnings expectations for almost every reporting period from 1997 through 1999.

A primary issue was how Xerox accounted for lease revenue. The revenue in Xerox's leasing arrangements represented three components: the value of the equipment, servicing over the life of the lease, and financing. The revenue from the equipment was recorded at the beginning of the lease and the revenues from servicing and financing were recognized over the life of the lease contract. According to the SEC complaint, Xerox took a number of actions to shift servicing and financing revenue to the value of the equipment, so that more of the revenue could be recognized immediately.

The SEC alleged that these actions were set by the one at the top and ordered six senior executives to pay over US$22 million in penalties and disgorgement of profits from their actions. Without admitting or denying the allegations made in the SEC complaint, Xerox agreed to pay a US$10 million fine, at that time the largest ever for a public company.


**Sales Returns and Allowances Cutoff**

Accounting standards require that sales returns and allowances be matched with related sales if the amounts are material. For example, if current period shipments are returned in the subsequent period, the sales return should appear in the current period. (The returned goods should be treated as current period inventory.) For most companies, however, sales returns and allowances are recorded in the accounting period in which they occur, under the assumption of approximately equal, offsetting amounts at the beginning and end of each accounting period. This approach is acceptable as long as the amounts are not material. Some companies establish a reserve, similar to the allowance for uncollectible accounts, for the expected amount of returns in the subsequent period.

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To some degree, auditors may also rely on the confirmation of accounts receivable to uncover cutoff misstatements for sales, sales returns and allowances, and cash receipts. However, it is often difficult to distinguish a cutoff misstatement from a normal timing difference due to shipments and payments in transit at year end.

The most important part of evaluating the client’s method of obtaining a reliable cutoff is to determine the procedures in use. When a client issues prenumbered shipping documents, it is usually a simple matter to evaluate and test cutoff. Moreover, the segregation of duties between the shipping and the billing function also enhances the likelihood of recording transactions in the proper period. However, if shipments are made by company truck, if the shipping records are unnumbered, and if shipping and billing personnel are not independent of each other, it may be difficult, if not impossible, to be assured of an accurate cutoff.

When the client’s internal controls are adequate, auditors can usually verify the cutoff by obtaining the shipping document number for the last shipment made at the end of the period and comparing this number with current and subsequent period recorded sales. As an illustration, assume the shipping document number for the last shipment in the current period is 1489. All recorded sales before the end of the period should bear a shipping document number preceding number 1480, and no sales recorded and shipped in the subsequent period should have a bill of lading numbered 1489 or lower. An auditor can easily test this by comparing recorded sales with the related shipping documents for the last few days of the current period and the first few days of the subsequent period.

**Timing difference**

A reported difference in a confirmation from a debtor that is determined to be a timing difference between the client’s and debtor’s records and therefore not a misstatement.

Timing difference
balances in accounts receivable
The amount of the outstanding accounts receivable

Part 3 / APPLICATION OF THE AUDIT PROCESS TO THE SALES AND COLLECTION CYCLE
Chapter 16 / COMPLETING THE TESTS IN THE SALES AND COLLECTION CYCLE

The Annual General Meeting of Media Production City Company (in an Arab country) was attended by the shareholders’ representatives, company employees, and the external auditors. The external auditors indicated a number of important misstatements in the company’s financial statements as at 31 December 2011 as follows:

1. The external auditor indicated a deficit in provisions for doubtful debts of US$24 million (the balance of the current provision being US$15 million) in addition to a deficit in provision for legal claims of US$24.3 million. A provision for a tax case amounting to US$13 million is also required. Management calculated an impairment of 25% of the total investments in “Media Soft” even though it continued to make losses for a number of years. In addition a similar impairment for a similar investment in “El Hooks” had not been calculated even though its accumulated losses represented 42% of the company’s capital according to the company’s financial statements at 2010.

2. The management of the company sold 76.67 square meters of land by tender. The external auditor claimed that the sale of the land is in violation of the acquisition contract of the land which gave the land to the company free based on a presidential decree and approval of the country prime minister, and that therefore management is not allowed to sell such land.

3. The external auditor also indicated that one of the buyers of the above land did not pay the installments due on 1 January and 11 April 2011 amounting to US$5.88 million. The total value of the land purchased was US$31.96 million. Instead of taking legal action against the buyer, management rescheduled the debts giving the buyer a grace period and adding 10.5% interest on the amounts outstanding. The auditor also objected to the recognition of capital gains made from the sale of the land showing the difference between the book value of the land and the market value and asked for the recognition of the capital gain only to the amount of installments received.

4. The external auditor indicated that management did not send confirmations for clients and credit balances amounting to US$15.5 million in addition to non-payment of stamp tax on advertisements made by the company amounting to US$13.57 million. The external auditor also indicated non-payment of balances by clients amounting to US$21 million which are considered bad debts resulting in overstatement of assets by such an amount.

For example, if a customer mails and records a check to a client for payment of an unpaid account on December 30 and the client receives and records the amount on January 2, the records of the two organizations will be different on December 31. This is not a cutoff misstatement, but a timing difference due to the delivery time. It may be difficult for the auditor to evaluate whether a cutoff misstatement or a timing difference occurred when a confirmation reply is the source of information. This type of situation requires additional investigation, such as inspection of supporting documents.

Accounts Receivable Is Stated at Realizable Value

Accounting standards require that companies state accounts receivable at the amount that will ultimately be collected. The realizable value of accounts receivable equals gross accounts receivable less the allowance for uncollectible accounts. To calculate the allowance, the client estimates the total amount of accounts receivable that it expects to be uncollectible. Obviously, clients cannot predict the future precisely, but it is necessary for the auditor to evaluate whether the client’s allowance is reasonable, considering all available facts. To assist with this evaluation, the auditor often prepares an audit schedule that analyzes the allowance for uncollectible accounts, as illustrated in Figure 16-4. In this example, the analysis indicates that the allowance is understated. This can be the result of the client failing to adjust the allowance or economic factors. Note that the potential understatement of the reserve was signaled by the analytical procedures in Table 16-3 for Arabian Hardware.

To begin the evaluation of the allowance for uncollectible accounts, the auditor reviews the results of the tests of controls that are concerned with the client’s credit policy. If the client’s credit policy has remained unchanged and the results of the tests of credit policy and credit approval are consistent with those of the preceding year, the change in the balance in the allowance for uncollectible accounts should reflect only changes in economic conditions and sales volume. However, if the client’s credit policy or the degree to which it correctly functions has significantly changed, auditors must take great care to consider the effects of these changes as well.

Auditors often evaluate the adequacy of the allowance by carefully examining the noncurrent accounts on the aged trial balance to determine which ones have not been paid subsequent to the balance sheet date. The size and age of unpaid balances can then be compared with similar information from previous years to evaluate whether the amount of noncurrent receivables is increasing or decreasing over time. Auditors also gain insights into the collectibility of the accounts by examining credit files, discussions with the credit manager, and review of the client’s correspondence file. These procedures are especially important if a few large balances are noncurrent and are not being paid on a regular basis.

Bad Debt Expense After the auditor is satisfied with the allowance for uncollectible accounts, it is easy to verify bad debt expense. Assume that:

• The beginning balance in the allowance account was verified as a part of the previous audit.
• The uncollectible accounts written off were verified as a part of the substantive tests of transactions.
• The ending balance in the allowance account has been verified by various means.

Bad debt expense is then simply a residual balance that can be verified by recalculation.

![FIGURE 16-4 Analysis of Allowance for Uncollectible Accounts Arabian Hardware Co.](image-url)

<table>
<thead>
<tr>
<th>AIR Category</th>
<th>AIR Balance</th>
<th>Estimated All. Percentage</th>
<th>Estimated Required Allowance</th>
</tr>
</thead>
<tbody>
<tr>
<td>0–30 days</td>
<td>US$317,156</td>
<td>3%</td>
<td>US$ 9,515</td>
</tr>
<tr>
<td>31–60 days</td>
<td>2,809,366</td>
<td>4%</td>
<td>172,162</td>
</tr>
<tr>
<td>61–90 days</td>
<td>1,008,645</td>
<td>15%</td>
<td>211,296</td>
</tr>
<tr>
<td>91–120 days</td>
<td>1,038,926</td>
<td>25%</td>
<td>259,732</td>
</tr>
<tr>
<td>Over 120</td>
<td>662,710</td>
<td>40%</td>
<td>265,084</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>US$29,196,800</strong></td>
<td><strong>40%</strong></td>
<td><strong>US$1,408,642</strong></td>
</tr>
</tbody>
</table>

- **Recorded Allowance**
  US$1,408,642

- **Difference**
  US$ 662,710

**Note:**
- TB = Traced to aged accounts receivable trial balance.
- TB = Allowance percentages are consistent with prior year, and appear reasonable based on historical loss percentages documented in permanent file.
- TB = Agreed to trial balance.

Conclusions:
- Recorded allowance appears understated based on aging analysis. Approximate amount of US$955,000 not considered material. Include on Summary of Possible Misstatements schedule on A-3. (See Figure 24-6 on page 798.)
that will ultimately be collected. Balances in accounts receivable are stated at the realizable value of
accounts receivable less the allowance for uncollectible accounts. As illustrated in Figure 16-4, in this example, the analysis indicates that the allowance is understated. This can be the result of the client failing to adjust the allowance for economic factors. Note that the potential understatement of the reserve was signaled by the analytical procedures in Table 16-3 for Arabian Hardware.

To begin the evaluation of the allowance for uncollectible accounts, the auditor reviews the results of the tests of controls that are concerned with the client’s credit policy. If the client’s credit policy has remained unchanged and the results of the tests of credit policy and credit approval are consistent with those of the preceding year, the change in the balance in the allowance for uncollectible accounts should reflect only changes in economic conditions and sales volume. However, if the client’s credit policy or the degree to which it correctly functions has significantly changed, auditors must take great care to consider the effects of these changes as well. Auditors often evaluate the adequacy of the allowance by carefully examining the noncurrent accounts on the aged trial balance to determine which ones have not been paid subsequent to the balance sheet date. The size and age of unpaid balances can then be compared with similar information from previous years to evaluate whether the amount of noncurrent receivables is increasing or decreasing over time. Auditors also gain insights into the collectibility of the accounts by examining credit files, discussions with the credit manager, and review of the client’s correspondence file. These procedures are especially important if a few large balances are noncurrent and are not being paid on a regular basis.

Bad Debt Expense After the auditor is satisfied with the allowance for uncollectible accounts, it is easy to verify bad debt expense. Assume that:

1. The beginning balance in the allowance account was verified as of the previous audit.
2. The noncollectable accounts written off were verified as a part of the substantive tests of transactions.
3. The ending balance in the allowance account has been verified by various means.

Bad debt expense is then simply a residual balance that can be verified by recalculation.

### FIGURE 16-4

Analysis of Allowance for Uncollectible Accounts

<table>
<thead>
<tr>
<th>Arabian Hardware Co. Analysis of Allowance for Uncollectible Accounts 31/1212</th>
<th>Schedule</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Prepared by</td>
<td>Approved by</td>
</tr>
<tr>
<td></td>
<td>TV</td>
<td>8/1/13</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>A/R</th>
<th>A/R Balance</th>
<th>Estimated Allowance</th>
<th>Required Allowance</th>
</tr>
</thead>
<tbody>
<tr>
<td>0–30 days</td>
<td>US$43,171,566</td>
<td>3%</td>
<td>US$1,240,000</td>
</tr>
<tr>
<td>31–60 days</td>
<td>2,869,366</td>
<td>4%</td>
<td>115,146</td>
</tr>
<tr>
<td>61–90 days</td>
<td>1,008,642</td>
<td>15%</td>
<td>151,296</td>
</tr>
<tr>
<td>91–120 days</td>
<td>1,038,926</td>
<td>25%</td>
<td>259,732</td>
</tr>
<tr>
<td>Over 120</td>
<td>662,710</td>
<td>40%</td>
<td>265,084</td>
</tr>
<tr>
<td>Total</td>
<td>US$20,196,800</td>
<td></td>
<td>US$334,769</td>
</tr>
</tbody>
</table>

Recorded Allowance US$334,769

Difference US$6,708

Conclusion: Recorded allowance appears understated based on aging analysis. Approximate amount of US$95,000 not considered material. Include on Summary of Possible Misstatements schedule on A-3. (See Figure 24-6 on page 708).

### MEDIA PRODUCTION CITY COMPANY MISSTATEMENTS

The Annual General Meeting of Media Production City Company (in an Arab country) was attended by the shareholders’ representatives, company employees, and the external auditors. The external auditors indicated a number of important misstatements in the company’s financial statements as at 31 December 2011 as follows:

1. The external auditor indicated a deficit in provisions for doubtful debts of US$24 million (the balance of the current payment of US$15 million in addition to a deficit in provision for legal claims of US$24.3 million. A provision for a tax case amounting to US$13 million is also required. Management calculated an impairment of 25% of the total investments in “Media Soft” even though it continued to make losses for a number of years. In addition a similar impairment for a similar investment in “El Hoda” had not been calculated even though its accumulated losses represented 42% of the company’s capital according to the company’s financial statements at 2010.
2. The management of the company sold 76.67 square meters of land by tender. The external auditor claimed the sale of the land is in violation of the acquisition contract of the land which gave the land to the company free based on a presidential decree and approval of the country prime minister, and that therefore management is not allowed to sell such land.
3. The external auditor also indicated that one of the buyers of the above land did not pay the installments due on 11 January and 11 April 2011 amounting to US$68 million. The total value of the land purchased was US$31.96 million. Instead of taking legal action against the buyer, management rescheduled the debts giving the buyer a grace period and adding 10.5% interest on the amounts outstanding. The auditor also objected to the recognition of capital gains made from the sale of the land showing the difference between the book value of the land and the market value and asked for the recognition of the capital gain only to the amount of installments received.
4. The external auditor indicated that management did not send confirmations for clients and credit balances amounting to US$155 million in addition to non-payment of stamp tax on advertisements made by the company amounting to US$13.57 million. The external auditor also indicated non-payment of balances by clients amounting to US$21 million which are considered bad debts resulting in overstatement of assets by such an amount.
The Client Has Rights to Accounts Receivable

The client’s rights to accounts receivable ordinarily cause no audit problems because the receivables usually belong to the client. In some cases, however, a portion of the receivables may have been pledged as collateral, assigned to someone else, factored, or sold at discount. Normally, the client’s customers are not aware of the existence of such matters, so the confirmation of receivables will not bring them to light. To uncover instances in which the client has limited rights to receivables, the auditor may review the minutes, discuss with the client, confirm with banks, examine debt contracts for evidence of accounts receivable pledged as collateral, and examine correspondence files.

Accounts Receivable Presentation and Disclosure

Tests of the four presentation and disclosure-related audit objectives are generally done as part of the completion phase of the audit. However, some tests of presentation and disclosure are often done with tests to meet the balance-related audit objectives. For example, when testing sales and accounts receivable, the auditor must understand and evaluate the appropriateness of the client’s revenue recognition policy to determine whether it is properly disclosed in the financial statements. The auditor must also decide whether the client has properly combined amounts and disclosed related party information in the statements. To evaluate the adequacy of the presentation and disclosure, the auditor must have a thorough understanding of accounting standards and presentation and disclosure requirements.

An important part of the evaluation involves deciding whether the client has segregated material amounts requiring separate disclosure in the statements. For example, receivables from officers and affiliated companies must be segregated from accounts receivable from customers if the amounts are material. Similarly, companies may disclose sales and assets for different business segments separately. The proper aggregation of general ledger balances in the financial statements also requires combining account balances that are not relevant for external users of the statements. If all accounts included in the general ledger were disclosed separately on the statements, most statement users would be more confused than enlightened.

CONFIRMATION OF ACCOUNTS RECEIVABLE

The primary purpose of accounts receivable confirmation, which is considered to be highly reliable audit evidence, is to satisfy the existence, accuracy, and cutoff objectives.

Types of Confirmation

In performing confirmation procedures, the auditor must decide the type of confirmation to use.

Positive Confirmation

A positive confirmation is a communication addressed to the debtor requesting the recipient to confirm directly whether the balance as stated on the confirmation request is correct or incorrect. Figure 16-5 illustrates a positive confirmation in the audit of Arabian Hardware Co.

A blank (or blind) confirmation form is a type of positive confirmation that does not state the amount on the confirmation but requests the recipient to fill in the balance or furnish other information. Because blank forms require the recipient to determine the information requested, they are considered more reliable than confirmations that include balance information. Blank forms are rarely used in practice because they often result in lower response rates.

An invoice confirmation is another type of positive confirmation in which an individual invoice is confirmed, rather than the customer’s entire accounts receivable balance. Many customers use voucher systems that allow them to confirm individual invoices but not balance information. As a result, the use of invoice confirmations may improve confirmation response rates. Invoice confirmations also result in fewer timing differences and other reconciling items than balance confirmations. However, invoice confirmations have the disadvantage of not directly confirming ending balances.

Sales to major customers often involve special terms or side-agreements for the return of goods that may affect the amount and timing of revenue to be recognized from the sale. To address these concerns, positive confirmations often request the customer to confirm the existence of any special terms or side-agreements between the client and customer.

FIGURE 16-5 An Example of a Positive Confirmation

Arabian Hardware Co.

MESSRS/ Arabian Hardware Co.

In connection with the examination of our accounts by our auditors, please confirm the correctness of the following balance(s) being indicated by our records as of December 31st 2011.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts Receivable</td>
<td>$4,629,396.36</td>
</tr>
</tbody>
</table>

If there are any discrepancies, please furnish details in your reply.

Thank you for your assistance.

Deputy Executive President & Financial Manager

The above statement is correct/ Incorrect

Name: ____________________________

Title: ____________________________

Discrepancies: ____________________________

DATE: ____________________________

 замена переменных на правильные значения: 552 / 553

PUT IT ON THE CARD

Sears, Roebuck & Co., the American retailer, was enjoying a remarkable turnaround in earnings in 1996. However, most of the increases in profits was attributable to interest on Sears credit card balances. In the early 1990s, Sears added more than 17 million new credit card customers. However, many of these new customers were not good credit risks, and they tended to carry high balances. As a result, in 1997, Sears had to increase its allowance for credit card delinquencies to US$393 million, a 44 percent increase. Unfortunately the delinquencies were only part of the problem. Many of these delinquent customers also filed for bankruptcy. In fact, by 1997 Sears was a creditor in more than one-third of all bankruptcies filed in the United States. Sears aggressively sought reaffirmation agreements with these customers, in which they pledged to continue making payments on their accounts.

However, many of these agreements were not filed in the bankruptcy cases, which meant the company was collecting on unenforceable agreements for debt that no longer legally existed. As a result of a federal investigation, Sears was forced to pay a US$60 million fine and set aside US$471 million in reserves to cover complaints over its debt collection practices. After continuing struggles with write-offs, Sears sold its credit card business to Citigroup in 2003.

The Client Has Rights to Accounts Receivable

The client’s rights to accounts receivable ordinarily cause no audit problems because the receivables usually belong to the client. In some cases, however, a portion of the receivables may have been pledged as collateral, assigned to someone else, factored, or sold at discount. Normally, the client’s customers are not aware of the existence of such matters, so the confirmation of receivables will not bring them to light. To uncover instances in which the client has limited rights to receivables, the auditor may review the minutes, discuss with the client, confirm with banks, examine debt contracts for evidence of accounts receivable pledged as collateral, and examine correspondence files.

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An important part of the evaluation involves deciding whether the client has segregated material amounts requiring separate disclosure in the statements. For example, receivables from officers and affiliated companies must be segregated from accounts receivable from customers if the amounts are material. Similarly, companies may disclose sales and assets for different business segments separately. The proper aggregation of general ledger balances in the financial statements also requires combining account balances that are not relevant for external users of the statements. If all accounts included in the general ledger were disclosed separately on the statements, most statement users would be more confused than enlightened.

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Sales to major customers often involve special terms or side-agreements for the return of goods that may affect the amount and timing of revenue to be recognized from the sale. To address these concerns, positive confirmations often request the customer to confirm the existence of any special terms or side-agreements between the client and customer.

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Deputy Executive President & Financial Manager

The above statement is correct/ Incorrect

Name: ____________________________

Title: ____________________________

Discrepancies: ____________________________

DATE: ____________________________
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The client’s rights to accounts receivable ordinarily cause no audit problems because the receivables usually belong to the client. In some cases, however, a portion of the receivables may have been pledged as collateral, assigned to someone else, factored, or sold at discount. Normally, the client’s customers are not aware of the existence of such matters, so the confirmation of receivables will not bring them to light. To uncover instances in which the client has limited rights to receivables, the auditor may review the minutes, discuss with the client, confirm with banks, examine debt contracts for evidence of accounts receivable pledged as collateral, and examine correspondence files.

Accounts Receivable Presentation and Disclosure

Tests of the four presentation and disclosure-related audit objectives are generally done as part of the completion phase of the audit. However, some tests of presentation and disclosure are often done with tests to meet the balance-related audit objectives. For example, when testing sales and accounts receivable, the auditor must understand and evaluate the appropriateness of the client’s revenue recognition policy to determine whether it is properly disclosed in the financial statements. The auditor must also decide whether the client has properly combined amounts and disclosed related party receivables from officers and affiliated companies. Similarly, companies may disclose sales and assets for different business segments separately. The proper aggregation of general ledger balances in the financial statements also requires combining account balances that are not relevant for external users of the statements. If all accounts included in the general ledger were disclosed separately on the statements, most statement users would be more confused than enlightened.

CONFIRMATION OF ACCOUNTS RECEIVABLE

The primary purpose of accounts receivable confirmation, which is considered to be highly reliable audit evidence, is to satisfy the existence, accuracy, and cutoff objectives.

Types of Confirmation

In performing confirmation procedures, the auditor must first decide the type of confirmation to use.

Positive Confirmation

A positive confirmation is a communication addressed to the debtor requesting the recipient to confirm directly whether the balance as stated on the confirmation request is correct or incorrect. Figure 16-5 illustrates a positive confirmation in the audit of Arabian Hardware Co.

A blank (or blind) confirmation form is a type of positive confirmation that does not state the amount on the confirmation but requests the recipient to fill in the balance or furnish other information. Because blank forms require the recipient to determine the information requested, they are considered more reliable than confirmations that include balance information. Blank forms are rarely used in practice because they often result in lower response rates.

An invoice confirmation is another type of positive confirmation in which an individual invoice is confirmed, rather than the customer’s entire accounts receivable balance. Many customers use voucher systems that allow them to confirm individual invoices but not balance information. As a result, the use of invoice confirmations may improve confirmation response rates. Invoice confirmations also result in fewer timing differences and other reconciling items than balance confirmations. However, invoice confirmations have the disadvantage of not directly confirming ending balances.

Sales to major customers often involve special terms or side-agreements for the return of goods that may affect the amount and timing of revenue to be recognized from the sale. To address these concerns, positive confirmations often request the customer to confirm the existence of any special terms or side-agreements between the client and customer.

**Figure 16-5** An Example of a Positive Confirmation

Arabian Hardware Co.

Alex. 13th February, 2012

MESSERS/Arabian Hardware Co.

In connection with the examination of our accounts by our auditors, please confirm the correctness of the following balance(s) being indicated by our records as of December 31st 2011:

<table>
<thead>
<tr>
<th>Balance</th>
<th>Currency</th>
</tr>
</thead>
<tbody>
<tr>
<td>4,629,396.36</td>
<td>US $</td>
</tr>
</tbody>
</table>

If there are any discrepancies, please furnish details in your reply.

Thanks for your assistance.

Deputy Executive President & Financial Manager

**Objective 16-4**

Obtain and evaluate accounts receivable confirmations.

Positive confirmation

A letter, addressed to the debtor, requesting the recipient to fill in the amount of the accounts receivable balance; it is considered a positive confirmation.

Blank or blind confirmation form

A letter, addressed to the debtor, requesting the recipient to fill in the amount of the accounts receivable balance; it is considered a positive confirmation.

Invoice confirmation

A type of positive confirmation in which an individual invoice is confirmed, rather than the customer’s entire accounts receivable balance.
negative confirmation
A letter addressed to the debtor requesting a response only if the recipient disagrees with the amount of the stated account balance.

Negative Confirmation  A negative confirmation is also addressed to the debtor but requests a response only when the debtor disagrees with the stated amount. Figure 16-6 illustrates a negative confirmation in the audit of Arabian Hardware Co. that has been attached to a customer’s monthly statement.

A positive confirmation is more reliable evidence because the auditor can perform follow-up procedures if a response is not received from the debtor. With a negative confirmation, failure to reply must be regarded as a correct response, even though the debtor may have ignored the confirmation request.

Offsetting the reliability disadvantage, negative confirmations are less expensive to send than positive confirmations, and thus more can be distributed for the same total cost. Negative confirmations cost less because there are no second requests and no follow-up of nonresponses.

The determination of which type of confirmation to use is an auditor’s decision, and it should be based on the facts in the audit. Auditing standards state that it is acceptable to use negative confirmations only when all three of the following circumstances are present:

1. Accounts receivable is made up of a large number of small accounts.
2. Combined assessed control risk and inherent risk is low. The combined risk is unlikely to be low if either internal controls are ineffective or there is a high expectation of misstatements. For example, if prior years’ audits indicate that accounts receivable are often disputed or inaccurate, negative confirmations are inappropriate.
3. There is no reason to believe that the recipients of the confirmations are unlikely to give them consideration. For example, if the response rate to positive confirmations in prior years was extremely high or if there are high response rates on confirmations of similar clients, it is likely that recipients will give negative confirmations reasonable consideration as well.

Typically, when negative confirmations are used, the auditor puts considerable emphasis on the effectiveness of internal controls, substantive tests of transactions, and analytical procedures as evidence of the fairness of accounts receivable, and assumes that the large majority of the recipients will provide a conscientious reading and response to the confirmation request.

Negative confirmations are often used for audits of hospitals, retail stores, banks, and other industries in which the receivables are due from the general public. It is also common to use a combination of negative and positive confirmations by sending the latter to accounts with large balances and the former to those with small balances.

The auditor’s choice of confirmation falls along a continuum, starting with the use of no confirmations in some circumstances, to using only negatives, to using both negatives and positives, to using only positives. The primary factors affecting the auditor’s decision are the materiality of total accounts receivable, the number and size of individual accounts, control risk, inherent risk, the effectiveness of confirmations as audit evidence, and the availability of other audit evidence.

Timing
The most reliable evidence from confirmations is obtained when they are sent as close to the balance sheet date as possible. This permits the auditor to directly test the accounts receivable balance on the financial statements without making any inferences about the transactions taking place between the confirmation date and the balance sheet date. However, as a means of completing the audit on a timely basis, it is often necessary to confirm the accounts at an interim date. This is permissible if internal controls are adequate and can provide reasonable assurance that sales, cash receipts, and other credits are properly recorded between the date of the confirmation and the end of the accounting period. The auditor is likely to consider other factors in making the decision, including the materiality of accounts receivable and the auditor’s exposure to lawsuits because of the possibility of client bankruptcy and similar risks.

If the decision is made to confirm accounts receivable before year-end, the auditor typically prepares a roll forward schedule that reconciles the accounts receivable balance at the confirmation date to accounts receivable at the balance sheet date. In addition to performing analytical procedures on the activity during the intervening period, it may be necessary to test the transactions occurring between the confirmation date and the balance sheet date. The auditor can accomplish this by examining internal documents such as duplicate sales invoices, shipping documents, and evidence of cash receipts.

Sampling Decisions
Sample Size  The major factors affecting sample size for confirming accounts receivable fall into several categories and include the following:

- Tolerable misstatement
- Inherent risk (relative size of total accounts receivable, number of accounts, prior-year results, and expected misstatements)
- Control risk
- Achieved detection risk from other substantive tests (extent and results of substantive tests of transactions, analytical procedures, and other tests of details)
- Type of confirmation (negatives normally require a larger sample size)

Selection of the Items for Testing  Some type of stratification is desirable with most confirmations. In a typical approach to stratification for selecting the balances for confirmation, an auditor considers both the dollar size of individual accounts and the length of time an account has been outstanding. In most audits, the emphasis should be on confirming larger and older balances because these are most likely to include a significant misstatement. But it is also important to sample some items from every material segment of the population. In many cases, the auditor selects all accounts above a certain dollar amount and selects a random sample from the remainder.

FIGURE 16-6  An Example of a Negative Bank Confirmation

Commercial Bank CB
Beiruth 27/II/2012
To Messrs Aziz A. B. and Co.
Re: Lebanon Oil Company as of 30/II/2012

Dear Sir,
Upon our customer request, we confirm the following information as of 30/II/2012:

<table>
<thead>
<tr>
<th>Account No.</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>03 95115948</td>
<td>USD 3277.57 ST CR</td>
</tr>
<tr>
<td>03 07315999</td>
<td>USD 4800.91 DR</td>
</tr>
<tr>
<td>03 95013899</td>
<td>EGP 22092.43 CR</td>
</tr>
<tr>
<td>03 93170919</td>
<td>USD ZERO</td>
</tr>
<tr>
<td>03 07014528</td>
<td>EGP ZERO</td>
</tr>
<tr>
<td>1. Time Deposit</td>
<td>NIL</td>
</tr>
<tr>
<td>2. Loans</td>
<td>NIL</td>
</tr>
</tbody>
</table>

This certificate is issued upon our customer’s request and without any responsibility on the bank or its officers.

Account Service Unit
Negative confirmation
A negative confirmation is also addressed to the debtor but requests a response only when the debtor disagrees with the stated amount. Figure 16-6 illustrates a negative confirmation in the audit of Arabian Hardware Co. that has been attached to a customer’s monthly statement.

A positive confirmation is more reliable evidence because the auditor can perform follow-up procedures if a response is not received from the debtor. With a negative confirmation, failure to reply must be regarded as a correct response, even though the debtor may have ignored the confirmation request.

Offsetting the reliability disadvantage, negative confirmations are less expensive to send than positive confirmations, and thus more can be distributed for the same total cost. Negative confirmations cost less because there are no second requests and no follow-up of nonresponses.

The determination of which type of confirmation to use is an auditor’s decision, and it should be based on the facts in the audit. Auditing standards state that it is acceptable to use negative confirmations only when all three of the following circumstances are present:

1. Accounts receivable is made up of a large number of small accounts.
2. Combined assessed control risk and inherent risk is low. The combined risk is unlikely to be low if either internal controls are ineffective or there is a high expectation of misstatements. For example, if prior years’ audits indicate that accounts receivable are often disputed or inaccurate, negative confirmations are inappropriate.
3. There is no reason to believe that the recipients of the confirmations are unlikely to give them consideration. For example, if the response rate to positive confirmations in prior years was extremely high or if there are high response rates on audits of similar clients, it is likely that recipients will give negative confirmations reasonable consideration as well.

Typically, when negative confirmations are used, the auditor puts considerable emphasis on the effectiveness of internal controls, substantive tests of transactions, and analytical procedures as evidence of the fairness of accounts receivable, and assumes that the large majority of the recipients will provide a conscientious reading and response to the confirmation request.

Negative confirmations are often used for audits of hospitals, retail stores, banks, and other industries in which the receivables are due from the general public. It is also common to use a combination of negative and positive confirmations by sending the latter to accounts with large balances and the former to those with small balances.

The auditor’s choice of confirmation falls along a continuum, starting with the use of no confirmations in some circumstances, to using only negatives, to using both negatives and positives, to using only positives. The primary factors affecting the auditor’s decision are the materiality of total accounts receivable, the number and size of individual accounts, control risk, inherent risk, the effectiveness of confirmations as audit evidence, and the availability of other audit evidence.

Timing
The most reliable evidence from confirmations is obtained when they are sent as close to the balance sheet date as possible. This permits the auditor to directly test the accounts receivable balance on the financial statements without making any inferences about the transactions taking place between the confirmation date and the balance sheet date. However, as a means of completing the audit on a timely basis, it is often necessary to confirm the accounts at an interim date. This is permissible if internal controls are adequate and can provide reasonable assurance that sales, cash receipts, and other credits are properly recorded between the date of the confirmation and the end of the accounting period. The auditor is likely to consider other factors in making the decision, including the materiality of accounts receivable and the auditor’s exposure to lawsuits because of the possibility of client bankruptcy and similar risks.

If the decision is made to confirm accounts receivable before year-end, the auditor typically prepares a roll forward schedule that reconciles the accounts receivable balance at the confirmation date to accounts receivable at the balance sheet date. In addition to performing analytical procedures on the activity during the intervening period, it may be necessary to test the transactions occurring between the confirmation date and the balance sheet date. The auditor can accomplish this by examining internal documents such as duplicate sales invoices, shipping documents, and evidence of cash receipts.

Sampling Decisions
Sample Size
The major factors affecting sample size for confirming accounts receivable fall into several categories and include the following:

- Tolerable misstatement
- Inherent risk (relative size of total accounts receivable, number of accounts, prior-year results, and expected misstatements)
- Control risk
- Achieved detection risk from other substantive tests (extent and results of substantive tests of transactions, analytical procedures, and other tests of details)
- Type of confirmation (negatives normally require a larger sample size)

Selection of the Items for Testing
Some type of stratification is desirable with most confirmations. In a typical approach to stratification for selecting the balances for confirmation, an auditor considers both the dollar size of individual accounts and the length of time an account has been outstanding. In most audits, the emphasis should be on confirming larger and older balances because these are most likely to include a significant misstatement. But it is also important to sample some items from every material segment of the population. In many cases, the auditor selects all accounts above a certain dollar amount and selects a random sample from the remainder.

FIGURE 16-6
An Example of a Negative Bank Confirmation

Commercial Bank CB
Bairuth 27/11/2012
To Messrs: Re: Lebanon Oil Company as of 30/12/2012
Dear Sirs,
Upon our customer request, we confirm the following information as of 31/12/2012:

1. Account No. Balance:
   03 951 5948 USD 3 777 77.57 CR
   03 073 1059 USD 1 000 00.00 DR
   03 950 1399 EGP 2 320 954.36 CR
   03 933 7019 USD 2 000 00.00 DR
   03 070 1452 EGP 2 309 294.36 CR
2. Time Deposit NIL
3. Loans NIL

This certificate is issued upon our customer’s request and without any responsibility on the bank or its officers.

Account Service Unit
When selecting a sample of accounts receivable for confirmation, the auditor should be careful to avoid being influenced by the client. If a client tries to discourage the auditor from sending confirmations to certain customers, the auditor should consider the possibility that the client is attempting to conceal fictitious or known misstatements of accounts receivable.

Maintaining Control

After the items for confirmation have been selected, the auditor must maintain control of the confirmations until they are returned from the customer. When the client assists by preparing the confirmations, enclosing them in envelopes, or putting stamps on the envelopes, close supervision by the auditor is required. A return address must be included on all envelopes to make sure that undelivered mail is received by the CPA firm. Similarly, self-addressed return envelopes accompanying the confirmations must be addressed for delivery to the CPA firm’s office. It is even important to mail the confirmations outside the client’s office. All of these steps are necessary to ensure independent communication between the auditor and the customer.

Follow-Up on Non Responses

It is inappropriate to regard confirmations mailed but not returned by customers as significant audit evidence. For example, nonresponses to positive confirmations do not provide audit evidence. Similarly, for negative confirmations, the auditor should not conclude that the recipient received the confirmation request and verified the information requested. Negative confirmations do, however, provide some evidence of the existence assertion.

When positive confirmations are used, auditing standards require follow-up procedures for confirmations not returned by the customer. It is common to send second and sometimes even third requests for confirmations. Even with these efforts, some customers do not return the confirmation, so it is necessary to follow up with alternative audit procedures. The objective of alternative procedures is to determine by a means other than confirmation whether the nonconfirmed account existed and was properly stated at the confirmation date. For any positive confirmation not returned, auditors can examine the following documentation to verify the existence and accuracy of individual sales transactions making up the ending balance in accounts receivable:

Subsequent Cash Receipts Evidence of the receipt of cash subsequent to the confirmation date includes examining remittance advices, entries in the cash receipts records, or perhaps even subsequent credits in the accounts receivable master file. On the one hand, the examination of evidence of subsequent cash receipts is a highly useful alternative procedure because it is reasonable to assume that a customer would not have made a payment unless it was an existing receivable. On the other hand, payment does not establish whether an obligation existed on the date of the confirmation.

In addition, auditors should take care to match each unpaid sales transaction with evidence of its subsequent payment as a test for disputes or disagreements over individual outstanding invoices.

Duplicate Sales Invoices These are useful in verifying the actual issuance of a sales invoice and the actual date of the billing.

Shipping Documents These are important in establishing whether the shipment was actually made and as a test of cutoff.

Correspondence with the Client Usually, the auditor does not need to review correspondence as a part of alternative procedures, but correspondence can be used to disclose disputed and questionable receivables not uncovered by other means.

The extent and nature of the alternative procedures depend primarily on the materiality of the nonresponses, the types of misstatements discovered in the confirmed responses, the subsequent cash receipts from the nonresponses, and the auditor’s conclusions about internal control.

It is normally desirable to account for all unconfirmed balances with alternative procedures even if the amounts are small, as a means of properly generalizing from the sample to the population. Another acceptable approach is to assume that nonresponses are 100 percent overstated amounts.

Analysis of Differences

When the confirmation requests are returned by the customer, the auditor must determine the reason for any reported differences. In many cases, they are caused by timing differences between the client’s and the customer’s records. It is important to distinguish between timing differences and exceptions, which represent misstatements of the accounts receivable balance.

The most commonly reported types of differences in confirmations include:

Payment Has Already Been Made Reported differences typically arise when the customer has made a payment before the confirmation date, but the client has not received the payment in time for recording before the confirmation date. Such instances should be carefully investigated to determine the possibility of a cash receipt’s cutoff misstatement, lying, or a theft of cash.

Goods Have Not Been Received These differences typically result because the client records the sale at the date of shipment and the customer records the acquisition when the goods are received. The time that the goods are in transit is often the cause of differences reported on confirmations. These should be investigated to determine the possibility of the customer not receiving the goods at all or the existence of a cutoff misstatement on the client’s records.

The Goods Have Been Returned The client’s failure to record a credit memo could have resulted from timing differences or the improper recording of sales returns and allowances. Like other differences, these must be investigated.

Clerical Errors and Disputed Amounts The most likely types of reported differences in a client’s records are when 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, and so forth. These differences must be investigated to determine whether the client is in error and the amount of the error.
Confirms are normally considered highly reliable evidence because they come from independent third parties. However, in some cases, customers have colluded with audit clients and returned false confirmation. Such was the case at U.S. Foodservice, Inc., a U.S. subsidiary of Royal Ahold, a company headquartered in the Netherlands. The SEC complaints charged that U.S. Foodservice inflated promotional allowances from vendors by as much as $700 million for fiscal years 2001 and 2002 in order to meet earnings targets. U.S. Foodservice personnel contacted vendors and pressured them to return false confirmation letters to the auditors. In two separate complaints, the SEC charged 16 individuals who were employees of or agents for vendors that supplied U.S. Foodservice.

When selecting a sample of accounts receivable for confirmation, the auditor should be careful to avoid being influenced by the client. If a client tries to discourage the auditor from sending confirmations to certain customers, the auditor should consider the possibility that the client is attempting to conceal fictitious or known misstatements of accounts receivable.

Maintaining Control

After the items for confirmation have been selected, the auditor must maintain control of the confirmations until they are returned from the customer. The client assists by preparing the confirmations, enclosing them in envelopes, or putting stamps on the envelopes, close supervision by the auditor is required. A return address must be included on all envelopes to make sure that undelivered mail is received by the CPA firm. Similarly, self-addressed return envelopes accompanying the confirmations must be addressed for delivery to the CPA firm’s office. It is even important to mail the confirmations outside the client’s office. All of these steps are necessary to ensure independent communication between the auditor and the customer.

Follow-Up on Non Responses

It is inappropriate to regard confirmations mailed but not returned by customers as significant audit evidence. For example, nonresponses to positive confirmations do not provide audit evidence. Similarly, for negative confirmations, the auditor should not conclude that the recipient received the confirmation request and verified the information requested. Negative confirmations do, however, provide some evidence of the existence assertion.

When positive confirmations are used, auditing standards require follow-up procedures for confirmations not returned by the customer. It is common to send second and sometimes even third requests for confirmations. Even with these efforts, some customers do not return the confirmation, so it is necessary to follow up with alternative audit procedures. The objective of alternative procedures is to determine by a means other than confirmation whether the nonconfirmed account existed and was properly stated at the confirmation date. For any positive confirmation not returned, auditors can examine the following documentation to verify the existence and accuracy of individual sales transactions making up the ending balance in accounts receivable:

Subsequent Cash Receipts Evidence of the receipt of cash subsequent to the confirmation date includes remittance advice, entries in the cash receipts records, or perhaps even subsequent credits in the accounts receivable master file. On the one hand, the examination of evidence of subsequent cash receipts is a highly useful alternative procedure because it is reasonable to assume that a customer would not have made a payment unless it was an existing receivable. On the other hand, pay- ment does not establish whether an obligation existed on the date of the confirmation. In addition, auditors should take care to match each unpaid sales transaction with evidence of its subsequent payment as a test for disputes or disagreements over individual outstanding invoices.

Duplicate Sales Invoices These are useful in verifying the actual issuance of a sales invoice and the actual date of the billing.

Shipping Documents These are important in establishing whether the shipment was actually made and as a test of cutoff.

Correspondence with the Client Usually, the auditor does not need to review correspondence as a part of alternative procedures, but correspondence can be used to disclose disputed and questionable receivables not uncovered by other means.

The extent and nature of the alternative procedures depend primarily on the materiality of the nonresponses, the types of misstatements discovered in the confirmed responses, the subsequent cash receipts from the nonresponses, and the auditor’s conclusions about internal control.

It is normally desirable to account for all unconfirmed balances with alternative procedures even if the amounts are small, as a means of properly generalizing from the sample to the population. Another acceptable approach is to assume that nonresponses are 100 percent overstated amounts.

Analysis of Differences

When the confirmation requests are returned by the customer, the auditor must determine the reason for any reported differences. In many cases, they are caused by timing differences between the client’s and the customer’s records. It is important to distinguish between timing differences and exceptions, which represent misstatements of the accounts receivable balance.

The most commonly reported types of differences in confirmations include:

Payment Has Already Been Made Reported differences typically arise when the customer has made a payment before the confirmation date, but the client has not received the payment in time for recording before the confirmation date. Such instances should be carefully investigated to determine the possibility of a cash receipt cutoff misstatement, lapsing, or a theft of cash.

Goods Have Not Been Received These differences typically result because the client records the sale at the date of shipment and the customer records the acquisition when the goods are received. The time that the goods are in transit is often the cause of differences reported on confirmations. These should be investigated to determine the possibility of the customer not receiving the goods at all or the existence of a cutoff misstatement on the client’s record.

The Goods Have Been Returned The client’s failure to record a credit memo could have resulted from timing differences or the improper recording of sales returns and allowances. Like other differences, these must be investigated.

Clerical Errors and Disputed Amounts The most likely types of reported differences in a client’s records are when 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, and so forth. These differences must be investigated to determine whether the client is in error and the amount of the error.
In most instances, the auditor will ask the client to reconcile the difference and, if necessary, will communicate with the customer to resolve any disagreements. Naturally, the auditor must carefully verify the client’s conclusions on each significant difference.

Drawing Conclusions

When all differences have been resolved, including those discovered in performing alternative procedures, the auditor must reevaluate internal control. Each client misstatement must be analyzed to determine whether it was consistent or inconsistent with the original assessed level of control risk. If a significant number of misstatements occurred that are inconsistent with the assessment of control risk, it is necessary to revise the assessment and consider the effect of the revision on the audit.

It is also necessary to generalize from the sample to the entire population of accounts receivable. Even though the sum of the misstatements in the sample may not significantly affect the financial statements, the auditor must consider whether the population is likely to be materially misstated. Generalizing from the sample to the population can be done using nonstatistical or statistical sampling techniques and is discussed in Chapter 17.

The auditor should always evaluate the qualitative nature of the misstatements found in the sample, regardless of the dollar amount of the estimated population misstatement. Even if the estimated misstatement is less than the tolerable misstatement for accounts receivable, the misstatements found in a sample can be symptomatic of a more serious problem.

The final decision about accounts receivable and sales is whether sufficient evidence has been obtained through tests of controls and substantive tests of transactions, analytical procedures, cutoff procedures, confirmation, and other substantive tests to justify drawing conclusions about the correctness of the stated balance.

**DEVELOPING TESTS OF DETAILS AUDIT PROGRAM**

We use Arabian Hardware Co. to illustrate the development of audit program procedures for tests of details in the sales and collection cycle, which serves as the summary of this chapter. The determination of these procedures is based on the tests of controls and substantive tests of transactions, as illustrated in Chapters 14 and 15, and the analytical procedures described earlier in this chapter.

Hosni Abdel Latif, the audit senior, prepared the evidence-planning worksheet in Figure 16-7 as an aid to help him decide the extent of planned tests of details of balances. The source of each of the rows is as follows:

- **Tolerable misstatement.** The preliminary judgment of materiality was set at US$442,000 (approximately 6 percent of earnings from operations of US$7,370,000). He allocated US$265,000 to the audit of accounts receivable (see page 559).
- **Acceptable audit risk.** Hosni assessed acceptable audit risk as high because of the good financial condition of the company, its financial stability, and the relatively small number of users of the financial statements.
- **Inherent risk.** Hosni assessed inherent risk as medium for existence and cutoff because of concerns over revenue recognition identified in SAS 99. Hosni also assessed inherent risk as medium for realizability value. In past years, the client made audit adjustments to the allowance for uncollectible accounts because it was found to be understated. Inherent risk was assessed as low for all other objectives.
- **Control risk.** Control risk assessments for each audit objective are the same as those in Figure 15-6 in Chapter 15. (Recall that results of tests of controls and substantive tests of transactions in Chapter 15 were consistent with the auditor’s initial control risk assessments, except for the accuracy and realizability value objectives for sales.)
- **Substantive tests of transactions results.** These results were also taken from Figure 15-6. (Recall from Chapter 15 that all results were acceptable except for the accuracy and cutoff objectives for sales.)
- **Analytical procedures.** See Tables 16-2 and 16-3.
- **Planned detection risk and planned audit evidence.** These two rows are decided for each objective based on the conclusions in the other rows.
Design audit procedures for the audit of accounts receivable, using an evidence-planning worksheet as a guide.

OBJECTIVE 16-5

We use Arabian Hardware Co. to illustrate the development of audit program procedures for tests of details in the sales and collection cycle, which serves as the summary of this chapter. The determination of these procedures is based on the tests of controls and substantive tests of transactions, as illustrated in Chapters 14 and 15, and the analytical procedures described earlier in this chapter.

Hosni Abdel Latif, the audit senior, prepared the evidence-planning worksheet in Figure 16-7 as an aid to help him decide the extent of planned tests of details of balances. The source of each of the rows is as follows:

- **Tolerable misstatement.** The preliminary judgment of materiality was set at US$442,000 (approximately 6 percent of earnings from operations of US$7,370,000). He allocated US$265,000 to the audit of accounts receivable (see page 559).
- **Acceptable audit risk.** Hosni assessed acceptable audit risk as high because of the good financial condition of the company, its financial stability, and the relatively small number of users of the financial statements.
- **Inherent risk.** Hosni assessed inherent risk as medium for existence and cutoff because of concerns over revenue recognition identified in SAS 99. Hosni also assessed inherent risk as medium for realizability value. In past years, the client made audit adjustments to the allowance for uncollectible accounts because it was found to be understated. Inherent risk was assessed as low for all other objectives.
- **Control risk.** Control risk assessments for each audit objective are the same as those in Figure 15-6 in Chapter 15. (Recall that results of tests of controls and substantive tests of transactions in Chapter 15 were consistent with the auditor's initial control risk assessments, except for the accuracy and realizability objectives for sales.)
- **Substantive tests of transactions results.** These results were also taken from Figure 15-6. (Recall from Chapter 15 that all results were acceptable except for the accuracy and cutoff objectives for sales.)
- **Analytical procedures.** See Tables 16-2 and 16-3.
- **Planned detection risk and planned audit evidence.** These two rows are decided for each objective based on the conclusions in the other rows.
Part 3 / APPLICATION OF THE AUDIT PROCESS TO THE SALES AND COLLECTION CYCLE

Chapter 16 / COMPLETING THE TESTS IN THE SALES AND COLLECTION CYCLE

### Table 16-4: Balance-Related Audit Objectives and Audit Program for Arabian Hardware Co.—Sales and Collection Cycle (Design Format)

<table>
<thead>
<tr>
<th>Balance-Related Audit Objective</th>
<th>Audit Procedure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable in the aged trial balance agree with related master file amounts, and the total is correctly added and agrees with the general ledger (detail to 1%)</td>
<td>Trace 10 accounts from the trial balance to accounts on master file (4). Confirm accounts receivable, using positive confirmations. Confirm all amounts over US$100,000 and a nonstatistical sample of the remainder (10). Perform alternative procedures for all confirmations not returned on the first or second request (11). Review accounts receivable trial balance for large and unusual receivables (1).</td>
</tr>
<tr>
<td>The accounts receivable on the aged trial balance exist (existence).</td>
<td>Confirm accounts receivable, using positive confirmations. Confirm all amounts over US$100,000 and a nonstatistical sample of the remainder (10). Perform alternative procedures for all confirmations not returned on the first or second request (11). Review accounts receivable trial balance for large and unusual receivables (1).</td>
</tr>
<tr>
<td>Existing accounts receivable are included in the aged trial balance (completeness).</td>
<td>Trace five accounts from the accounts receivable master file to the aged trial balance (9).</td>
</tr>
<tr>
<td>Accounts receivable in the trial balance are accurate (accuracy).</td>
<td>Confirm accounts receivable, using positive confirmations. Confirm all amounts over US$100,000 and a nonstatistical sample of the remainder (10). Perform alternative procedures for all confirmations not returned on the first or second request (11). Review accounts receivable trial balance for large and unusual receivables (1).</td>
</tr>
<tr>
<td>Accounts receivable on the aged trial balance are correctly classified (classification).</td>
<td>Review the receivables listed on the aged trial balance for notes and related party receivables (3). Inquire of management whether there are any related party notes or long-term receivables included in the trial balance (4).</td>
</tr>
<tr>
<td>Transactions in the sales and collection cycle are recorded in the proper period (cutoff).</td>
<td>Select the last 20 sales transactions from the current year’s sales journal and the first 20 from the subsequent year’s and trace each to the related shipping documents, checking for the date of actual shipment and the correct recording (14). Review large sales returns and allowances before and after the balance sheet date to determine whether they are recorded in the correct period (15).</td>
</tr>
<tr>
<td>Accounts receivable is stated at realizable value (realizable value).</td>
<td>Trace 10 accounts from the aging schedule to the accounts receivable master file to test for the correct aging on the trial balance (6). Foot the aging columns on the trial balance and total all pages (7). Cross-foot the aging columns (7). Discuss with the credit manager the likelihood of collecting older accounts. Examine subsequent cash receipts and the credit file on all accounts over 90 days and evaluate whether the receivables are collectible (12). Evaluate whether the allowance is adequate after performing other audit procedures for collectibility of receivables (13).</td>
</tr>
<tr>
<td>The client has rights to accounts receivable on the trial balance (rights).</td>
<td>Review the minutes of the board of directors meetings for any indication of pledged or factored accounts receivable (5). Inquire of management whether any receivables are pledged or factored (5).</td>
</tr>
</tbody>
</table>

Table 16-4 shows the tests of details audit program for accounts receivable, by objective, and for the allowance for uncollectible accounts. The audit program reflects the conclusions for planned audit evidence on the evidence-planning worksheet in Figure 16-7.

A summary of the audit procedures contained in Table 16-5 shows audit program for receivables. The audit procedures are identical to those in Table 16-4 except for procedure 2, which is an analytical procedure. The numbers in parentheses are a cross reference between the two tables.

### Table 16-5: Test of Details of Balances Audit Program for Arabian Hardware Company—Sales and Collection Cycle (Performance Format)

1. Review accounts receivable trial balance for large and unusual receivables.
2. Calculate analytical procedures indicated in carry-forward audit schedules (not included) and follow up on any significant changes from prior years.
3. Review the receivables listed on the aged trial balance for notes and related party receivables.
4. Inquire of management whether there are any related party notes, or long-term receivables included in the trial balance.
5. Review the minutes of the board of directors meetings and inquiries of management to determine whether any receivables are pledged or factored.
6. Trace 10 accounts from the trial balance to the accounts receivable master file for aging and the balance.
7. Foot two pages of the trial balance for aging columns and balance, total all pages and cross-foot the aging.
8. Trace the balance to the general ledger.
9. Trace five accounts from the accounts receivable master file to the aged trial balance.
10. Confirm accounts receivable, using positive confirmations. Confirm all amounts over US$100,000 and a nonstatistical sample of the remainder.
11. Perform alternative procedures for all confirmations not returned on the first or second request.
12. Discuss with the credit manager the likelihood of collecting older accounts. Examine subsequent cash receipts and the credit file on all larger accounts over 90 days and evaluate whether the receivables are collectible.
13. Evaluate whether the allowance is adequate after performing other audit procedures for collectibility of receivables.
14. Select the last 20 sales transactions from the current year’s sales journal and the first 20 from the subsequent year’s and trace each to the related shipping documents, checking for the date of actual shipment and the correct recording.
15. Review large sales returns and allowances before and after the balance sheet date to determine whether they are recorded in the correct period.

This chapter introduced the procedures related to the test of balances of the sales and collection cycle. This cycle is considered an important process in the audit of business enterprises mainly for manufacturing companies. Documents and procedures related to the test of details of balances and the application of analytical procedures for the sales and collection cycle were presented showing the role of the external auditor in checking the reliability of accounts associated with the cycle. Various audit objectives were analyzed showing how auditors can use various audit evidence to achieve these objectives taking into consideration the effects of the auditor’s assessment of the internal control on financial reporting.

### Essential Terms

- Accounts receivable balance-related audit objectives p. 339
- Aged trial balance p. 546
- Alternative audit procedures p. 556
- Blank or blind confirmation form p. 553
- Cutoff misstatements p. 548
- Invoice confirmation p. 553
- Negative confirmation p. 554
- Positive confirmation p. 553
- Realizable value of accounts receivable p. 550
- Timing difference p. 549

### Summary

This chapter introduced the procedures related to the test of balances of the sales and collection cycle. This cycle is considered an important process in the audit of business enterprises mainly for manufacturing companies. Documents and procedures related to the test of details of balances and the application of analytical procedures for the sales and collection cycle were presented showing the role of the external auditor in checking the reliability of accounts associated with the cycle. Various audit objectives were analyzed showing how auditors can use various audit evidence to achieve these objectives taking into consideration the effects of the auditor’s assessment of the internal control on financial reporting.
The client has rights to accounts receivable on the trial balance (rights).

Accounts receivable on the aged trial balance exist (existence).

The accounts receivable on the aged trial balance are accurate (accuracy).

Existing accounts receivable are included in the aged trial balance (completeness).

Accounts receivable in the trial balance are accurate (accuracy).

Accounts receivable in the aged trial balance are accurate (accuracy).

Transactions in the sales and collection cycle are recorded in the proper period (cutoff).

Accounts receivable in the aged trial balance are stated at realizable value (realizable value).

The client has rights to accounts receivable on the trial balance (rights).

Table 16-4 shows the tests of details audit program for accounts receivable, by objective, and for the allowance for uncollectible accounts. The audit program reflects the conclusions for planned audit evidence on the evidence-planning worksheet in Figure 16-7.

**TABLE 16-4** Balance-Related Audit Objectives and Audit Program for Arabian Hardware Co.—Sales and Collection Cycle (Design Format)

<table>
<thead>
<tr>
<th>Balance-Related Audit Objective</th>
<th>Audit Procedure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable in the aged trial balance agree with related master file amounts, and the total is correctly added and agrees with the general ledger (detail test).</td>
<td>Trace 10 accounts from the trial balance to accounts on master file (6).</td>
</tr>
<tr>
<td>The accounts receivable on the aged trial balance exist (existence).</td>
<td>Confirm accounts receivable, using positive confirmations. Confirm all amounts over US$100,000 and a nonstatistical sample of the remainder (10).</td>
</tr>
<tr>
<td>Accounts receivable in the trial balance are accurate (accuracy).</td>
<td>Confirm accounts receivable, using positive confirmations. Confirm all amounts over US$100,000 and a nonstatistical sample of the remainder (10).</td>
</tr>
<tr>
<td>Existing accounts receivable are included in the aged trial balance (completeness).</td>
<td>Trace five accounts from the accounts receivable master file to the aged trial balance (9).</td>
</tr>
<tr>
<td>Accounts receivable in the aged trial balance are accurate (accuracy).</td>
<td>Review accounts receivable trial balance for large and unusual receivables (1).</td>
</tr>
<tr>
<td>Accounts receivable in the aged trial balance are accurately classified (classification).</td>
<td>Review the receivables listed on the aged trial balance for notes and related party receivables (3).</td>
</tr>
<tr>
<td>Transactions in the sales and collection cycle are recorded in the proper period (cutoff).</td>
<td>Select the last 20 sales transactions from the current year’s sales journal and the first 20 from the subsequent year’s and trace each to the related shipping documents, checking for the date of actual shipment and the correct recording (14).</td>
</tr>
<tr>
<td>Accounts receivable is stated at realizable value (realizable value).</td>
<td>Trace 10 accounts from the aging schedule to the accounts receivable master file to test for the correct aging on the trial balance (6).</td>
</tr>
<tr>
<td>The client has rights to accounts receivable on the trial balance (rights).</td>
<td>Review the minutes of the board of directors meetings for any indication of pledged or factored accounts receivable (5).</td>
</tr>
</tbody>
</table>

**TABLE 16-5** Test of Details of Balances Audit Program for Arabian Hardware Company—Sales and Collection Cycle (Performance Format)

1. Review accounts receivable trial balance for large and unusual receivables.
2. Calculate analytical procedures indicated in carry-forward audit schedules (not included) and follow up on any significant changes from prior years.
3. Review the receivables listed on the aged trial balance for notes and related party receivables.
4. Inquire of management whether there are any related party notes, or long-term receivables included in the trial balance.
5. Review the minutes of the board of directors meetings and inquiries of management to determine whether any receivables are pledged or factored.
6. Trace 10 accounts from the trial balance to the accounts receivable master file for aging and the balance.
7. Foot two pages of the trial balance for aging columns and balance, total all pages and cross-foot the aging.
8. Trace the balance to the general ledger.
9. Trace five accounts from the accounts receivable master file to the aged trial balance.
10. Confirm accounts receivable, using positive confirmations. Confirm all amounts over US$100,000 and a nonstatistical sample of the remainder.
11. Perform alternative procedures for all confirmations not returned on the first or second request.
12. Discuss with the credit manager the likelihood of collecting older accounts. Examine subsequent cash receipts and the credit file on all larger accounts over 90 days and evaluate whether the receivables are collectible.
13. Evaluate whether the allowance is adequate after performing other audit procedures for collectibility of receivables.
14. Select the last 20 sales transactions from the current year’s sales journal and the first 20 from the subsequent year’s and trace each to the related shipping documents, checking for the date of actual shipment and the correct recording.
15. Review large sales returns and allowances before and after the balance sheet date to determine whether they are recorded in the correct period.

**SUMMARY**

This chapter introduced the procedures related to the test of balances of the sales and collection cycle. This cycle is considered an important process in the audit of business enterprises mainly for manufacturing companies. Documents and procedures related to the test of details of balances and the application of analytical procedures for the sales and collection cycle were presented showing the role of the external auditor in checking the reliability of accounts associated with the cycle. Various audit objectives were analyzed showing how auditors can use various audit evidence to achieve these objectives taking into consideration the effects of the auditor’s assessment of the internal control on financial reporting.

**ESSENTIAL TERMS**

- Accounts receivable balance-related audit objectives p. 339
- Aged trial balance p. 546
- Alternative audit procedures p. 556
- Blank or blind confirmation form p. 553
- Cutoff misstatements p. 548
- Invoice confirmation p. 553
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**Part 3 / APPLICATION OF THE AUDIT PROCESS TO THE SALES AND COLLECTION CYCLE**

**Chapter 16 / COMPLETING THE TESTS IN THE SALES AND COLLECTION CYCLE**

**MULTIPLE CHOICE QUESTIONS FROM CPA EXAMINATIONS**

**16-14 (Objective 16-4)** Define what is meant by alternative procedures in the confirmation of accounts receivable and explain their purpose. Which alternative procedures are the most reliable? Why?

**16-15 (Objective 16-4)** Explain why the analysis of differences is important in the confirmation of accounts receivable, even if the misstatements in the sample are not material.

**16-16 (Objective 16-4)** State three types of differences that might be observed in the confirmation of accounts receivable that do not constitute misstatements. For each, state an audit procedure that will verify the difference.

**16-17 (Objective 16-1)** What is the relationship of each of the following to the sales and collection cycle: flowcharts, assessing control risk, tests of controls, and tests of details of balances?

**16-18 (Objective 16-3)** Customers purchasing products through a company's internet website generally pay for those goods by providing their personal credit card information. Describe how a company's sale of products through its website affects the auditor's tests of accounts receivable in the financial statement audit.
16-1 (Objective 16-1) Distinguish among tests of details of balances, tests of controls, and substantive tests of transactions for the sales and collection cycle. Explain how the tests of controls and substantive tests of transactions affect the tests of details of balances.

16-2 (Objective 16-1) Mohamed El Batran, an auditor, expresses the following viewpoint: "I do not believe in performing tests of controls and substantive tests of transactions for the sales and collection cycle. As an alternative, I send a lot of negative confirmations on every audit at an interim date. If I find a lot of misstatements, I analyze them to determine their cause. If internal controls are inadequate, I send positive confirmations at year-end to evaluate the amount of misstatements. If the negative confirmations result in minimal misstatements, which is often the case, I have found that the internal controls are effective without bothering to perform tests of controls and substantive tests of transactions, and the confirmation requirement has been satisfied at the same time. In my opinion, the best test of internal controls is to go directly to third parties." Evaluate his point of view.

16-3 (Objective 16-2) List five analytical procedures for the sales and collection cycle. For each test, describe a misstatement that could be identified.

16-4 (Objective 16-3) Identify the seven accounts receivable balance-related audit objectives. For each objective, list one audit procedure.

16-5 (Objective 16-3) Which of the seven accounts receivable balance-related audit objectives can be partially satisfied by confirmations with customers?

16-6 (Objective 16-3) State the purpose of footing the total column in the client's accounts receivable trial balance, tracing individual customer names and amounts to the accounts receivable master file, and tracing the total to the general ledger. Is it necessary to trace each amount to the master file? Why?

16-7 (Objective 16-3) Distinguish between accuracy tests of gross accounts receivable and tests of the realizable value of receivables.

16-8 (Objective 16-3) Explain why you agree or disagree with the following statement: "In most audits, it is more important to test carefully the cutoff for sales than for cash receipts." Describe how you perform each type of test, assuming documents are prenumbered.

16-9 (Objective 16-4) Evaluate the following statement: "In many audits in which accounts receivable are material, the requirement of confirming customer balances is a waste of time and would not be performed by competent auditors if it were not required by auditing standards. When internal controls are excellent and there are a large number of small receivables from customers who do not recognize the function of confirmation, it is a meaningless procedure. Examples include well-run utilities and retail stores. In these situations, tests of controls and substantive tests of transactions are far more effective than confirmations."

16-10 (Objective 16-4) Distinguish between a positive and a negative confirmation and state the circumstances in which each should be used. Why do auditing firms sometimes use a combination of positive and negative confirmations on the same audit?

16-11 (Objective 16-4) Under what circumstances is it acceptable to confirm accounts receivable before the balance sheet date?

16-12 (Objective 16-4) State the most important factors affecting the sample size in confirmations of accounts receivable.

16-13 (Objective 16-4) In Chapter 15, one of the points brought out was the need to obtain a representative sample of the population. How can this concept be reconciled with the statement in this chapter that the emphasis should be on confirming larger and older balances because these are most likely to contain misstatements?

16-14 (Objective 16-4) Define what is meant by alternative procedures in the confirmation of accounts receivable and explain their purpose. Which alternative procedures are the most reliable? Why?

16-15 (Objective 16-4) Explain why the analysis of differences is important in the confirmation of accounts receivable, even if the misstatements in the sample are not material.

16-16 (Objective 16-4) State three types of differences that might be observed in the confirmation of accounts receivable that do not constitute misstatements. For each, state an audit procedure that will verify the difference.

16-17 (Objective 16-1) What is the relationship of each of the following to the sales and collection cycle: flowcharts, assessing control risk, tests of controls, and tests of details of balances?

16-18 (Objective 16-3) Customers purchasing products through a company's internet website generally pay for those goods by providing their personal credit card information. Describe how a company's sale of products through its website affects the auditor's tests of accounts receivable in the financial statement audit.

MULTIPLE CHOICE QUESTIONS FROM CPA EXAMINATIONS

16-19 (Objective 16-2) The following questions concern analytical procedures in the sales and collection cycle. Choose the best response.

a. As a result of analytical procedures, the auditor determines that the gross profit percentage has declined from 30% in the preceding year to 20% in the current year. The auditor should
   (1) express a qualified opinion due to inability of the client company to continue as a going concern.
   (2) evaluate management's performance in causing this decline.
   (3) require footnote disclosure.
   (4) consider the possibility of a misstatement in the financial statements.

b. After an auditor has determined that accounts receivable have increased as a result of slow collections in a 'tight money' environment, the auditor will be likely to
   (1) increase the balance in the allowance for bad debt account.
   (2) review the going concern ramifications.
   (3) require footnote disclosure.
   (4) expand tests of collectibility.

c. In connection with his review of key ratios, the auditor notes that Hassan Kamal had accounts receivable equal to 30 days' sales at December 31, 2010, and to 45 days' sales at December 31, 2011. Assuming that there have been no changes in economic conditions, clientele, or sales mix, this change most likely will indicate
   (1) a steady increase in sales in 2011.
   (2) an easing of credit policies in 2011.
   (3) a decrease in accounts receivable relative to sales in 2011.
   (4) a steady decrease in sales in 2011.

16-20 (Objective 16-4) The following questions deal with confirmation of accounts receivable. Choose the best response.

a. The negative form of accounts receivable confirmation request is useful except when
   (1) internal control surrounding accounts receivable is considered to be effective.
   (2) a large number of small balances are involved.
   (3) the auditor has reason to believe the persons receiving the requests are likely to give them consideration.
   (4) individual account balances are relatively large.
b. The return of a positive confirmation of accounts receivable without an exception attests to the
   (1) collectibility of the receivable balance.
   (2) accuracy of the receivable balance.
   (3) accuracy of the aging of accounts receivable.
   (4) accuracy of the allowance for uncollectible accounts.

c. In confirming a client's accounts receivable in prior years, an auditor found that there were many differences between the recorded account balances and the confirmation responses. These differences, which were not misstatements, required substantial time to resolve. In defining the sampling unit for the current year's audit, the auditor will most likely choose
   (1) individual overdue balances.  (2) individual invoices.
   (3) small account balances.  (4) large account balances.

16-21 (Objective 16-3) The following questions concern audit objectives and management assertions for accounts receivable. Choose the best response.

a. When evaluating the adequacy of the allowance for uncollectible accounts, an auditor reviews the entity's aging of receivables to support management's balance-related assertion of
   (1) existence.
   (2) completeness.
   (3) valuation and allocation.
   (4) rights and obligations.

b. Which of the following audit procedures will best uncover an understatement of sales and accounts receivable?
   (1) Test a sample of sales transactions, selecting the sample from prenumbered shipping documents.
   (2) Test a sample of sales transactions, selecting the sample from sales invoices recorded in the sales journal.
   (3) Confirm accounts receivable.
   (4) Review the aged accounts receivable trial balance.

16-22 (Objective 16-3) The following are the seven balance-related audit objectives, seven tests of details of balances for accounts receivable, and seven tests of controls or substantive tests of transactions for the sales and collection cycle:

<table>
<thead>
<tr>
<th>Balance-Related Audit Objectives</th>
<th>Test of Details of Balances, Test of Control, or Substantive Test of Transactions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Detail vs. in</td>
<td>Audit Procedure</td>
</tr>
<tr>
<td>Existence</td>
<td>Confirm accounts receivable.</td>
</tr>
<tr>
<td>Completeness</td>
<td>Review sales returns after the balance sheet date to determine whether any are applicable to the current year.</td>
</tr>
<tr>
<td>Accuracy</td>
<td>Compare dates on shipping documents and the sales journal throughout the year.</td>
</tr>
<tr>
<td></td>
<td>Perform alternative procedures for nonresponses to confirmation.</td>
</tr>
</tbody>
</table>

DISCUSSION QUESTIONS AND PROBLEMS

16-23 (Objective 16-3) The following are common tests of details of balances for the audit of accounts receivable:

1. Obtain a list of aged accounts receivable, foot the list, and trace the total to the general ledger.
2. Trace 35 accounts to the accounts receivable master file for name, amount, and age categories.
3. Examine and document cash receipts on accounts receivable for 20 days after the engagement date.
4. Request 25 positive and 65 negative confirmations of accounts receivable.
5. Perform alternative procedures on accounts not responding to second requests by examining subsequent cash receipts documentation and shipping reports or sales invoices.
6. Test the sales cutoff by tracing entries in the sales journal for 15 days before and after the balance sheet date to shipping documents, if available, and/or sales invoices.
7. Determine whether any accounts receivable have been pledged, discounted, sold, assigned, or guaranteed by others.
8. Evaluate the materiality of credit balances in the aged trial balance.

For each audit procedure, identify the balance-related audit objective or objectives it partially or fully satisfies.

16-24 (Objective 16-3) The following misstatements are sometimes found in the sales and collection cycle's account balances:

1. Several accounts receivable in the accounts receivable master file are not included in the aged trial balance.
2. One account receivable in the accounts receivable master file is included on the aged trial balance.
3. Cash received from collections of accounts receivable in the subsequent period is recorded as current period receipts.
b. The return of a positive confirmation of accounts receivable without an exception attests to the
   (1) collectibility of the receivable balance.
   (2) accuracy of the receivable balance.
   (3) accuracy of the aging of accounts receivable.
   (4) accuracy of the allowance for uncollectible accounts.
   c. In confirming a client’s accounts receivable in prior years, an auditor found that there
   were many differences between the recorded account balances and the confirmation
   responses. These differences, which were not misstatements, required substantial time
   to resolve. In defining the sampling unit for the current year’s audit, the auditor will
   most likely choose
   (1) individual overdue balances.
   (2) individual invoices.
   (3) small account balances.
   (4) large account balances.

16-21 (Objective 16-3) The following questions concern audit objectives and management
assertions for accounts receivable. Choose the best response.

a. When evaluating the adequacy of the allowance for uncollectible accounts, an audi-
tor reviews the entity’s aging of receivables to support management’s balance-related
assertion of
   (1) existence.
   (2) completeness.
   (3) valuation and allocation.
   (4) rights and obligations.

b. Which of the following audit procedures will best uncover an understatement of sales
   and accounts receivable?
   (1) Test a sample of sales transactions, selecting the sample from prenumbered ship-
       ping documents.
   (2) Test a sample of sales transactions, selecting the sample from sales invoices
       recorded in the sales journal.
   (3) Confirm accounts receivable.
   (4) Review the aged accounts receivable trial balance.

Discussion Questions and Problems

16-22 (Objective 16-3) The following are the seven balance-related audit objectives, seven
tests of details of balances for accounts receivable, and seven tests of controls or substantive
tests of transactions for the sales and collection cycle:

<table>
<thead>
<tr>
<th>Balance-Related Audit Objectives</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Collectibility</td>
<td>Payment due</td>
</tr>
<tr>
<td>Accuracy</td>
<td>Payment due</td>
</tr>
<tr>
<td>Completeness</td>
<td>Payment due</td>
</tr>
<tr>
<td>Realizable value</td>
<td>Payment due</td>
</tr>
</tbody>
</table>

Audit Procedure

Test of Details of Balances, Test of Control, or Substantive Test of Transactions
Audit Procedure

1. Confirm accounts receivable.
2. Review sales returns after the balance sheet date to determine whether any are appli-
cable to the current year.
3. Compare dates on shipping documents and the sales journal throughout the year.
4. Perform alternative procedures for nonresponses to confirmation.

Chapter 16 / Completing the Tests in the Sales and Collection Cycle

5. Examine sales transactions for related party or employee sales recorded as regular
   sales.
6. Examine duplicate sales invoices for consignment sales and other shipments for
   which title has not passed.
7. Trace a sample of accounts from the accounts receivable master file to the aged trial
   balance.
8. Trace recorded sales transactions to shipping documents to determine whether a
   document exists.
9. Examine duplicate sales invoices for initials that indicate internal verification of
   extensions and footings.
10. Trace a sample of shipping documents to related sales invoice entries in the sales
    journal.
11. Compare amounts and dates on the aged trial balance and accounts receivable
    master file.
12. Trace from the sales journal to the accounts receivable master file to make sure the
    information is the same.
13. Inquire of management whether there are notes from related parties included with trade receivables.

Identify which procedures are tests of details of balances, which are tests of controls,
and which are substantive tests of transactions.

b. Identify one test of details and one test of control or substantive test of transactions
that will partially satisfy each balance-related audit objective. Each procedure must be
used at least once.

16-23 (Objective 16-3) The following are common tests of details of balances for the audit
of accounts receivable:

1. Obtain a list of aged accounts receivable, foot the list, and trace the total to the gen-
   eral ledger.
2. Trace 35 accounts to the accounts receivable master file for name, amount, and age
   categories.
3. Examine and document cash receipts on accounts receivable for 20 days after the
   engagement date.
4. Request 25 positive and 65 negative confirmations of accounts receivable.
5. Perform alternative procedures on accounts not responding to second requests by
   examining subsequent cash receipts documentation and shipping reports or sales
   invoices.
6. Test the sales cutoff by tracing entries in the sales journal for 15 days before and
   after the balance sheet date to shipping documents, if available, and/or sales
   invoices.
7. Determine whether any accounts receivable have been pledged, discounted, sold,
   assigned, or guaranteed by others.
8. Evaluate the materiality of credit balances in the aged trial balance.

For each audit procedure, identify the balance-related audit objective or objectives it
partially or fully satisfies.

16-24 (Objective 16-3) The following misstatements are sometimes found in the sales and
collection cycle’s accounts balances:

1. Several accounts receivable in the accounts receivable master file are not included in
   the aged trial balance.
2. One account receivable in the accounts receivable master file is included on the aged
   trial balance twice.
3. Cash received from collections of accounts receivable in the subsequent period is
   recorded as current period receipts.
4. The allowance for uncollectible accounts is inadequate because of the client's failure to reflect depressed economic conditions in the allowance.
5. Several accounts receivable are in dispute as a result of claims of defective merchandise.
6. The pledging of accounts receivable to the bank for a loan is not disclosed in the financial statements.
7. Goods shipped and included in the current period sales were returned in the subsequent period.
8. Long-term interest-bearing notes receivable from affiliated companies are included in accounts receivable.
9. The trial balance total does not equal the amount in the general ledger.

a. For each misstatement, identify the balance-related audit objective to which it pertains.
b. For each misstatement, list an internal control that should prevent it.
c. For each misstatement, list one test of details of balances audit procedure that the auditor can use to detect it.

16-25 (Objective 16-3) The following are audit procedures in the sales and collection cycle:
1. Examine a sample of shipping documents to determine whether each has a sales invoice number included on it.
2. Examine a sample of noncash credits in the accounts receivable master file to determine if the internal auditor has initialed each, indicating internal verification.
3. Discuss with the sales manager whether any sales allowances have been granted after the balance sheet date that may apply to the current period.
4. Add the columns on the aged trial balance and compare the total with the general ledger.
5. Examine a sample of customer orders and see if each has a credit authorization.
6. Compare the date on a sample of shipping documents a few days before and after the balance sheet date with related sales journal transactions.
7. Examine a sample of shipping documents to determine whether each has a sales invoice number included on it.
8. Compare the date on a sample of shipping documents throughout the year with related duplicate sales invoices and the accounts receivable master file.
9. Compute the ratio of allowance for uncollectible accounts divided by accounts receivable and compare with previous years.

a. For each procedure, identify the applicable type of audit evidence.
b. For each procedure, identify which of the following it is:
   (1) Test of control
   (2) Substantive test of transactions
   (3) Analytical procedure
   (4) Test of details of balances
c. For those procedures you identified as a test of control or substantive test of transactions, what transaction-related audit objective or objectives are being satisfied?
d. For those procedures you identified as a test of details of balances, what balance-related audit objective or objectives are being satisfied?

16-26 (Objective 16-3) Abou El Yousr Foodstuffs sells products to small grocery stores. Prenumbered shipping documents are required by the company to be issued for each sale. The shipping clerk writes the date on the shipping document whenever there is a shipment or pickup. The final shipment made in the fiscal year ending June 30, 2010, was recorded on document 5427. Shipments are billed in the order the billing clerk receives the shipping documents. For late June and early July, shipping documents are billed on sales invoices as follows:

<table>
<thead>
<tr>
<th>Shipping Document No.</th>
<th>Sales Invoice No.</th>
</tr>
</thead>
<tbody>
<tr>
<td>5423</td>
<td>6237</td>
</tr>
<tr>
<td>5424</td>
<td>6223</td>
</tr>
<tr>
<td>5425</td>
<td>6224</td>
</tr>
<tr>
<td>5426</td>
<td>6235</td>
</tr>
<tr>
<td>5427</td>
<td>6236</td>
</tr>
<tr>
<td>5428</td>
<td>6216</td>
</tr>
<tr>
<td>5429</td>
<td>6238</td>
</tr>
<tr>
<td>5430</td>
<td>6242</td>
</tr>
<tr>
<td>5431</td>
<td>6231</td>
</tr>
<tr>
<td>5432</td>
<td>6219</td>
</tr>
</tbody>
</table>

The June and July sales journals have the following information included:

<table>
<thead>
<tr>
<th>DAY OF MONTH</th>
<th>SALES JOURNAL—JUNE 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Day of Month</td>
</tr>
<tr>
<td>23</td>
<td>6223</td>
</tr>
<tr>
<td>27</td>
<td>6226</td>
</tr>
<tr>
<td>28</td>
<td>6225</td>
</tr>
<tr>
<td>30</td>
<td>6242</td>
</tr>
<tr>
<td>30</td>
<td>6236</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>DAY OF MONTH</th>
<th>SALES JOURNAL—JULY 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Day of Month</td>
</tr>
<tr>
<td>3</td>
<td>6237</td>
</tr>
<tr>
<td>3</td>
<td>6229</td>
</tr>
<tr>
<td>4</td>
<td>6238</td>
</tr>
<tr>
<td>5</td>
<td>6216</td>
</tr>
<tr>
<td>6</td>
<td>6231</td>
</tr>
</tbody>
</table>

a. What are the accounting standards requirements for a correct sales cutoff? 
b. Which sales invoices, if any, are recorded in the wrong accounting period? Prepare an adjusting entry to correct the financial statements for the year ending June 30, 2010. Assume that the company uses a periodic inventory system (i.e., inventory and cost of sales do not need to be adjusted).
c. Assume that the shipping clerk accidentally wrote June 30 on shipping documents 5428 through 5430. Explain how that will affect the correctness of the financial statements. How will you, as an auditor, discover that error? 
d. Describe, in general terms, the audit procedures you would follow in making sure that cutoff for sales is accurate at the balance sheet date.
e. Identify internal controls that will reduce the likelihood of cutoff misstatements. How would you test each control? 

16-27 (Objectives 16-2, 16-3) The Radio & Electronic Company sells electronics equipment, and has grown rapidly in the last year by adding new customers. The audit partner...
4. The allowance for uncollectible accounts is inadequate because of the client’s failure to reflect depressed economic conditions in the allowance.
5. Several accounts receivable are in dispute as a result of claims of defective merchandise.
6. The pledging of accounts receivable to the bank for a loan is not disclosed in the financial statements.
7. Goods shipped and included in the current period sales were returned in the subsequent period.
8. Long-term interest-bearing notes receivable from affiliated companies are included in accounts receivable.
9. The trial balance total does not equal the amount in the general ledger.

a. For each misstatement, identify the balance-related audit objective to which it pertains.
b. For each misstatement, list an internal control that should prevent it.
c. For each misstatement, list one test of details of balances audit procedure that the auditor can use to detect it.

16-25 (Objective 16-3) The following are audit procedures in the sales and collection cycle:
1. Examine a sample of shipping documents to determine whether each has a sales invoice number included on it.
2. Examine a sample of noncash credits in the accounts receivable master file to determine if the internal auditor has initialed each, indicating internal verification.
3. Discuss with the sales manager whether any sales allowances have been granted after the balance sheet date that may apply to the current period.
4. Add the columns on the aged trial balance and compare with previous years.
5. Observe whether the controller makes an independent comparison of the total in the general ledger with the trial balance of accounts receivable.
6. Examine a sample of noncash credits in the accounts receivable master file to determine if the internal auditor has initialed each, indicating internal verification.
7. Examine a sample of shipping documents to determine whether each has a sales invoice number included on it.
8. Compare the date on a sample of shipping documents throughout the year with the balance sheet date with related sales journal transactions.
9. Compute the ratio of allowance for uncollectible accounts divided by accounts receivable and compare with previous years.

a. For each procedure, identify the applicable type of audit evidence.
b. For each procedure, identify which of the following it is:
   (1) Test of control
   (2) Substantive test of transactions
   (3) Analytical procedure
   (4) Test of details of balances
c. For those procedures you identified as a test of control or substantive test of transactions, what transaction-related audit objective or objectives are being satisfied?
d. For those procedures you identified as a test of details of balances, what balance-related audit objective or objectives are being satisfied?

16-26 (Objective 16-3) Abou El Yousr Foodstuffs sells products to small grocery stores. Prenumbered shipping documents are required by the company to be issued for each sale. The shipping clerk writes the date on the shipping document whenever there is a shipment or pickup. The final shipment made in the fiscal year ending June 30, 2010, was recorded on document 5427. Shipments are billed in the order the billing clerk receives the shipping documents. For late June and early July, shipping documents are billed on sales invoices as follows:

<table>
<thead>
<tr>
<th>Ship Date</th>
<th>Shipping Document No.</th>
<th>Sales Invoice No.</th>
<th>Amount of Sale (US$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 July</td>
<td>5428</td>
<td>6229</td>
<td>7,216.49</td>
</tr>
<tr>
<td>2 July</td>
<td>5427</td>
<td>6237</td>
<td>699.32</td>
</tr>
<tr>
<td>6 July</td>
<td>5426</td>
<td>6223</td>
<td>2,978.61</td>
</tr>
<tr>
<td>11 July</td>
<td>5425</td>
<td>6226</td>
<td>504.96</td>
</tr>
<tr>
<td>16 July</td>
<td>5424</td>
<td>6224</td>
<td>827.23</td>
</tr>
<tr>
<td>21 July</td>
<td>5423</td>
<td>6223</td>
<td>35.42</td>
</tr>
</tbody>
</table>

a. What are the accounting standards requirements for a correct sales cutoff?
b. Which sales invoices, if any, are recorded in the wrong accounting period? Prepare an adjusting entry to correct the financial statements for the year ending June 30, 2010. Assume that the company uses a periodic inventory system (i.e., inventory and cost of sales do not need to be adjusted).
c. Assume that the company uses a periodic inventory system (i.e., inventory and cost of sales do not need to be adjusted).
d. Assume that the company uses a periodic inventory system (i.e., inventory and cost of sales do not need to be adjusted).
e. Identify internal controls that will reduce the likelihood of cutoff misstatements. How would you test each control?

16-27 (Objectives 16-2, 16-3) The Radio & Electronic Company sells electronics equipment, and has grown rapidly in the last year by adding new customers. The audit partner...
has asked you to evaluate the allowance for doubtful accounts at December 31, 2011. Comparative information on sales and accounts receivable is included below:

<table>
<thead>
<tr>
<th></th>
<th>Year Ended</th>
<th>Year Ended</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>31/12/10</td>
<td>31/12/11</td>
</tr>
<tr>
<td>Sales</td>
<td>US$12,169,876</td>
<td>US$10,452,513</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>1,440,381</td>
<td>1,030,933</td>
</tr>
<tr>
<td>Allowance for doubtful accounts</td>
<td>90,000</td>
<td>75,000</td>
</tr>
<tr>
<td>Bad debt charge-offs</td>
<td>114,849</td>
<td>103,471</td>
</tr>
<tr>
<td>Accounts Receivable (0–30 days)</td>
<td>US$97,035</td>
<td>US$695,041</td>
</tr>
<tr>
<td>Accounts Receivable (30–60 days)</td>
<td>254,269</td>
<td>160,989</td>
</tr>
<tr>
<td>Accounts Receivable (60–90 days)</td>
<td>171,846</td>
<td>105,997</td>
</tr>
<tr>
<td>Accounts Receivable (Over 90 days)</td>
<td>117,231</td>
<td>68,906</td>
</tr>
<tr>
<td>TOTAL</td>
<td>US$1,440,381</td>
<td>US$1,030,933</td>
</tr>
</tbody>
</table>

1. Confirmation request no. 9
Customer name—Obaida Milling Co.
Balance—US$3,621 at December 31, 2010
Subsequent cash receipts per the accounts receivable master file:
- January 15, 2011—US$1,837
- January 29, 2011—US$1,263
- February 6, 2011—US$1,429

2. Confirmation request no. 26
Customer name—ATP Repair Service
Balance—US$22,500 at December 31, 2010
Subsequent cash receipts per the accounts receivable master file:
- February 9, 2011—US$500

Sales invoices per the accounts receivable master file (I examined the duplicate invoice):
- September 1, 2010—US$4,200

a. Identify what tests of controls and substantive tests of transactions you recommend be performed before conducting your analysis of the allowance for doubtful accounts.

b. Perform analytical procedures to evaluate whether the allowance is fairly stated at December 31, 2011. Assume tolerable misstatement for the allowance account is US$15,000.

16-28 (Objective 16-4) In the confirmation of accounts receivable for the Reliable Service Company, 85 positive and no negative confirmations were mailed to customers. This represents 35% of the dollar balance of the total accounts receivable. Second requests were sent for all nonresponses, but there were still 10 customers who did not respond. The decision was made to perform alternative procedures on the 10 unanswered confirmation requests. An assistant is requested to conduct the alternative procedures and report to the senior auditor after he has completed his tests on two accounts. He prepared the following information for the audit files:

1. Confirmation request no. 9
Customer name—Obaida Milling Co.
Balance—US$3,621 at December 31, 2010
Subsequent cash receipts per the accounts receivable master file:
- January 15, 2011—US$1,837
- January 29, 2011—US$1,263
- February 6, 2011—US$1,429

2. Confirmation request no. 26
Customer name—ATP Repair Service
Balance—US$22,500 at December 31, 2010
Subsequent cash receipts per the accounts receivable master file:
- February 9, 2011—US$500

Sales invoices per the accounts receivable master file (I examined the duplicate invoice):
- September 1, 2010—US$4,200

a. If you are called on to evaluate the adequacy of the sample size, the type of confirmations used, and the percent of accounts confirmed, what additional information will you need?
b. Discuss the need to send second requests and perform alternative procedures for nonresponses.
c. Evaluate the adequacy of the alternative procedures used for verifying the two nonresponses.

16-29 (Objective 16-4) You have been assigned to the confirmation of aged accounts receivable for the Blank Paper Company audit. You have tested the aged trial balance and selected the accounts for confirming. Before the confirmation requests are mailed, the controller asks to look at the accounts you intend to confirm to determine whether he will permit you to send them.

He reviews the list and informs you that he does not want you to confirm six of the accounts on your list. Two of them are credit balances, one is a zero balance, two of the other three have a fairly small balance, and the remaining balance is highly material. The reason he gives is that he feels the confirmations will upset these customers because “they are kind of hard to get along with.” He does not want the credit balances confirmed because it may encourage the customer to ask for a refund.

In addition, the controller asks you to send an additional 20 confirmations to customers he has listed for you. He does this as a means of credit collection for “those stupid idiots who won’t know the difference between an auditor and a credit collection agency.”

1. Is it acceptable for the controller to review the list of accounts you intend to confirm? Discuss.
2. Discuss the appropriateness of sending the 20 additional confirmations to the customers.
3. Assuming that the auditor complies with all the controller’s requests, what is the effect on the auditor’s opinion?

16-30 Objectives Data Company operates in the information technology field to serve the banking and the services sectors. The company is preparing statistics to be distributed to its customers through an information network. Currently 70 employees work in the company. The draft accounts of the company indicate that the revenues amounted to US$750,000 and net profit amounted to US$33,340 for the year ended 31/12/2010.

Sixty-seventy percent of the company’s stocks are owned by members of the board of directors, and 33 percent by an Indian company working in the field of information technology which invested in Data Company in 2011. As part of the business deal the Indian company designated a non-executive director from outside the company. The following notes were acquired during the initial audit of the company for the year ended 31/12/2010 and are left for you for a decision.

1. The Revenues:
   - The revenues are collected by yearly subscription for using the information network of Data Company Subscriptions and can be collected in advance at the beginning of the year, or on a monthly basis.
   - The current revenues recognition policy:
     - 65% of the revenues are realized in January.
     - 35% of the revenues are realized equally over 11 months.
   - The board of directors justified the use of this policy using the argument that most of the costs of providing their customers with the network are incurred at the beginning of the year. The costs of the programs and collecting the data are incurred before offering the product to the market. The board of directors indicated that most of the marketing and administrative costs are incurred during the stage of customer recruitment and not in the after sales stage.

2. Intangible Assets:
   - The draft accounts indicated that there is an intangible asset of US$216,670 representing the patent for developing the company’s programs.
   - The company is capitalizing the development costs to be depreciated over three years if the project starts to earn profits.
   - Without that asset the balance sheet will give negative net assets.
has asked you to evaluate the allowance for doubtful accounts at December 31, 2011. Comparative information on sales and accounts receivable is included below:

<table>
<thead>
<tr>
<th></th>
<th>Year Ended 31/12/10</th>
<th>Year Ended 31/12/11</th>
</tr>
</thead>
<tbody>
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<tr>
<td>Accounts Receivable</td>
<td></td>
<td></td>
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<tr>
<td>0–30 days</td>
<td>US$897,035</td>
<td>US$695,041</td>
</tr>
<tr>
<td>30–60 days</td>
<td>254,269</td>
<td>160,989</td>
</tr>
<tr>
<td>60–90 days</td>
<td>171,846</td>
<td>105,977</td>
</tr>
<tr>
<td>Over 90 days</td>
<td>117,231</td>
<td>68,906</td>
</tr>
<tr>
<td>TOTAL</td>
<td>1,440,381</td>
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</tr>
</tbody>
</table>

1. Confirmation request no. 9
   Customer name—Obaida Milling Co.
   Balance—US$3,621 at December 31, 2010
   Subsequent cash receipts per the accounts receivable master file:
   January 15, 2011—US$1,837
   January 29, 2011—US$1,263
   February 6, 2011—US$1,429

2. Confirmation request no. 26
   Customer name—ATP Repair Service
   Balance—US$2,500 at December 31, 2010
   Subsequent cash receipts per the accounts receivable master file
   February 9, 2011—US$500
   Sales invoices per the accounts receivable master file (I examined the duplicate invoice)
   September 1, 2010—US$4,200

16-28 (Objective 16-4) In the confirmation of accounts receivable for the Reliable Service Company, 85 positive and no negative confirmations were mailed to customers. This represents 35% of the dollar balance of the total accounts receivable. Second requests were sent for all nonresponses, but there were still 10 customers who did not respond. The decision was made to perform alternative procedures on the 10 unanswered confirmation requests.

An assistant is requested to conduct the alternative procedures and report to the senior controller after he has completed his tests on two accounts. He prepared the following information for all nonresponses, but there were still 10 customers who did not respond. The decision was made to perform alternative procedures on the 10 unanswered confirmation requests.

He reviews the list and informs you that he does not want you to confirm six of the accounts on your list. Two of them are credit balances, one is a zero balance, two of the other three have a fairly small balance, and the remaining balance is highly material. The reason he gives is that he feels the confirmations will upset these customers because they are kind of hard to get along with.” He does not want the credit balances confirmed because it may encourage the customer to ask for a refund. In addition, the controller asks you to send an additional 20 confirmations to customers he has listed for you. He does this as a means of credit collection for “those stupid idiots who won’t know the difference between an auditor and a credit collection agency.”

Required
a. Identify what tests of controls and substantive tests of transactions you recommend be performed before conducting your analysis of the allowance for doubtful accounts.

b. Perform analytical procedures to evaluate whether the allowance is fairly stated at December 31, 2011. Assume tolerable misstatement for the allowance account is US$15,000.

16-29 (Objective 16-4) The draft accounts of the company indicate that the revenues amounted to US$750,000 and net profit amounted to US$33,340 for the year ended 31/12/2010. The company is preparing statistics to be distributed to its customers through an information network. Currently 70 employees work in the company. The draft accounts of the company indicate that the revenues amounted to US$875,000 and net profit amounted to US$33,340 for the year ended 31/12/2010.

Sixty-seven percent of the company’s stocks are owned by members of the board of directors, and 33 percent by an Indian company working in the field of information technology which invested in Data Company in 2011. As part of the business deal the Indian company designated a non-executive director from outside the company. The following notes were acquired during the initial audit of the company for the year ended 31/12/2010 and are left for you for a decision.

1. The Revenues:
   a. The revenues are collected by yearly subscription for using the information network of Data Company Subscriptions and can be collected in advance at the beginning of the year, or on a monthly basis.
   b. The current revenues recognition policy:
      • 65% of the revenues are realized in January.
      • 35% of the revenues are realized equally over 11 months.
   c. The board of directors justified the use of this policy using the argument that most of the costs of providing their customers with the network are incurred at the beginning of the year. The costs of the programs and collecting the data are incurred before offering the product to the market. The board of directors indicated that most of the marketing and administrative costs are incurred during the stage of customer recruitment and not in the after sales stage.

2. Intangible Assets:
   The draft accounts indicated that there is an intangible asset of US$216,670 representing the patent for developing the company’s programs. The company is capitalizing the development costs to be depreciated over three years if the project starts to earn profits.

Without that asset the balance sheet will give negative net assets.
3. Loans:
   As part of the business agreement with the Indian company, it was agreed that:
   - The quick ratio or cash cover should not be less than two times.
   - The profits should be at least three times interest coverage ratio.
   - The board of directors informed you that the contracts terms are not followed and it is not expected to be followed in the next 12 months.

Required

For each of the above notes:
1. Comment on the issues that should be taken into consideration.
2. Determine the appropriate audit guidance.

16-31 (Objectives 16-1, 16-3, 16-4, 16-5) You are auditing the sales and collection cycle for Zoro Electronics, a small electronics manufacturer, who deals with a variety of computer makers. The company is respected in its industry for its creativity and rapid growth, but their accounting office is perpetually neglected, and the sales department frequently makes errors in billing clients. In previous years, your auditing firm has found quite a few misstatements in billings, cash receipts, and accounts receivable. Like many companies, the largest assets are accounts receivable, inventory, and fixed assets.

Zoro Electronics has several large loans payable to local banks, and the two banks have told management that they are reluctant to extend more credit, especially considering that a bigger and well known electronics manufacturer is moving into the area. In previous slow years Zoro Electronics covered deficits with capital it had saved, but its recent expansion has diminished its capital reserves substantially.

In previous years, your response from clients of Zoro Electronics to confirmation requests has been frustrating at best. The response rate has been extremely low, and those who did reply did not know the purpose of the confirmation or their correct outstanding balance. You have had the same experience in confirming receivables with other, similar organizations. You conclude that control over cash is excellent and the likelihood of fraud is extremely small. You are less confident about unintentional errors in billing, recording sales, cash receipts, accounts receivable, and bad debts.

Required

a. Identify the major factors affecting client business risk and acceptable audit risk for this audit.

b. What inherent risks are you concerned about?

c. In this audit of the sale and collection cycle, which types of tests are you likely to emphasize?

d. For each of the following, explain whether you plan to emphasize the tests and give reasons:
   - Tests of controls
   - Confirmations
   - Substantive tests of transactions
   - Analytical procedures
   - Tests of details of balances

ACL PROBLEM

16-32 (Objective 16-3) This problem requires the use of ACL software, which is included in the CD attached to the text. Information about installing and using ACL and solving this problem can be found in the Appendix, pages 853–857. You should read all of the reference material preceding the instructions for ‘Quick Sort’ before locating the appropriate command to answer questions a–f. For this problem use the Metaphor_Trans_All file in ACL Demo, which is a file of outstanding sales invoices (each row represents an invoice transaction). The suggested command or other source of information needed to solve the problem requirement is included at the end of each question.

a. Determine the total number of invoices (read the bottom of the Metaphor_Trans_All file screen) and total unpaid invoices outstanding (NEWBAL) for comparison to the general ledger. (Total Field)

b. How many of the invoices included a finance charge (FINCHG) and what was the total amount of the finance charges? (Filter, Count Records, and Total Field)

c. Determine and print accounts receivable outstanding from each customer and total the amount for comparison to part a (Note: remove the filter from step b first). (Summarize and Total Field) Which customer number has the largest balance due?

d. What is the largest and smallest account balance outstanding? (Quick Sort)

e. For the account with the largest balance, prepare and print an aging of the account from the transaction file using the statement date labeled ‘STMTTDT.’ Use the aging date as of 30/4/2003 and ‘NEWBAL’ as the subtotal field. (Filter and Age)

f. To better decide the customers to select for confirmation you decide to stratify customer balances into two intervals after excluding all balances less than US$5,000. How many balances are greater than US$5,000? Print the output. (Filter and Stratify)
Part 3 / APPLICATION OF THE AUDIT PROCESS TO THE SALES AND COLLECTION CYCLE

Chapter 16 / COMPLETING THE TESTS IN THE SALES AND COLLECTION CYCLE

3. Loans:
   As part of the business agreement with the Indian company, it was agreed that:
   - The quick ratio or cash cover should not be less than two times.
   - The profits should be at least three times interest coverage ratio.
   - The board of directors informed you that the contracts terms are not followed and it is not expected to be followed in the next 12 months.

Required For each of the above notes:
1. Comment on the issues that should be taken into consideration.
2. Determine the appropriate audit guidance.

16-31 (Objectives 16-1, 16-3, 16-4, 16-5) You are auditing the sales and collection cycle for Zoro Electronics, a small electronics manufacturer, who deals with a variety of computer makers. The company is respected in its industry for its creativity and rapid growth, but their accounting office is perpetually neglected, and the sales department frequently makes errors in billing clients. In previous years, your auditing firm has found quite a few misstatements in billings, cash receipts, and accounts receivable. Like many companies, the largest assets are accounts receivable, inventory, and fixed assets.

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Required a. Identify the major factors affecting client business risk and acceptable audit risk for this audit.
b. What inherent risks are you concerned about?
c. In this audit of the sale and collection cycle, which types of tests are you likely to emphasize?
d. For each of the following, explain whether you plan to emphasize the tests and give reasons:
   (1) Tests of controls
   (2) Confirmations
   (3) Substantive tests of transactions
   (4) Analytical procedures
   (5) Tests of details of balances

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a. Determine the total number of invoices (read the bottom of the Metaphor_Trans_All file screen) and total unpaid invoices outstanding (NEWBAL) for comparison to the general ledger. (Total Field)
b. How many of the invoices included a finance charge (FINCHG) and what was the total amount of the finance charges? (Filter, Count Records, and Total Field)
c. Determine and print accounts receivable outstanding from each customer and total the amount for comparison to part a (Note: remove the filter from step b first). (Summarize and Total Field) Which customer number has the largest balance due?
d. What is the largest and smallest account balance outstanding? (Quick Sort)
e. For the account with the largest balance, prepare and print an aging of the account from the transaction file using the statement date labeled ‘STMTTDT’. Use the aging date as of 30/4/2003 and ‘NEWBAL’ as the subtotal field. (Filter and Age)
f. To better decide the customers to select for confirmation you decide to stratify customer balances into two intervals after excluding all balances less than US$5,000. How many balances are greater than US$5,000? Print the output. (Filter and Stratify)
Dear Shareholders

March 29, 2013

We are proud to announce another year of noticeable improvement.

In last year’s letter we stated, “We are committed to increasing the efficiency and effectiveness of operations through cost savings and productivity improvements, in light of current economic conditions. In addition, we intend to maintain and further develop our customer base through recently implemented post-sale service programs.” The operating results in this report demonstrate that our objectives have been achieved, resulting in a net income increase of US$740,000 from 2011 to 2012. This amounts to 15 cents per share, a 23.2% increase from last year. Our goal in the current year is to further improve the results of operations and create value for shareholders. In doing so, we will focus primarily on the following three strategic components of our business plan:

1. Post-sale service arrangements designed to further develop and maintain our customer base.
2. Aggressive advertising campaigns that allow us to penetrate markets dominated by regional wholesale hardware store chains.
3. Implementation of new warehouse technology designed to increase productivity and reduce stocking and distribution costs.

We will report our progress throughout the year.

Falih Al-Habib
Chief Executive Officer

Rasheed Akrum
President and Chief Operating Officer
### Arabian Hardware Company
#### Statement of Cash Flows (in thousands)

<table>
<thead>
<tr>
<th>Year Ended December 31</th>
<th>2012</th>
<th>2011</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjustments to reconcile net income to net cash provided by (used in) operating activities:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation and amortization</td>
<td>1,462</td>
<td>1,443</td>
<td>1,505</td>
</tr>
<tr>
<td>Gain or Loss on sale of assets</td>
<td>(720)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Deferred income taxes increase (decrease)</td>
<td>16</td>
<td>(9)</td>
<td>43</td>
</tr>
<tr>
<td>Changes in assets and liabilities:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trade and other receivables</td>
<td>(2,777)</td>
<td>(393)</td>
<td>(918)</td>
</tr>
<tr>
<td>Merchandise inventory</td>
<td>1,735</td>
<td>(295)</td>
<td>(430)</td>
</tr>
<tr>
<td>Prepaid expenses</td>
<td>(6)</td>
<td>(27)</td>
<td>(55)</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>288</td>
<td>132</td>
<td>76</td>
</tr>
<tr>
<td>Accrued liabilities</td>
<td>714</td>
<td>77</td>
<td>142</td>
</tr>
<tr>
<td>Income taxes payable</td>
<td>273</td>
<td>23</td>
<td>13</td>
</tr>
<tr>
<td>Net cash provided by operating activities</td>
<td>4,910</td>
<td>4,146</td>
<td>2,655</td>
</tr>
<tr>
<td>INVESTING ACTIVITIES</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital expenditures</td>
<td>(10,500)</td>
<td>(1,800)</td>
<td>(2,292)</td>
</tr>
<tr>
<td>Sale of equipment</td>
<td>10,324</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Net cash used in investing activities</td>
<td>(176)</td>
<td>(1,800)</td>
<td>(2,292)</td>
</tr>
<tr>
<td>FINANCING ACTIVITIES</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividend payment</td>
<td>(1,900)</td>
<td>(1,900)</td>
<td>(1,900)</td>
</tr>
<tr>
<td>Proceeds (repayments) from borrowings (net)</td>
<td>(2,749)</td>
<td>(423)</td>
<td>1,602</td>
</tr>
<tr>
<td>Net cash used in financing activities</td>
<td>(4,449)</td>
<td>(2,323)</td>
<td>(238)</td>
</tr>
<tr>
<td>Net increase in cash and cash equivalents</td>
<td>85</td>
<td>23</td>
<td>65</td>
</tr>
<tr>
<td>Cash and cash equivalents at beginning of year</td>
<td>743</td>
<td>720</td>
<td>655</td>
</tr>
<tr>
<td>Cash and cash equivalents at end of year</td>
<td>US$ 828</td>
<td>US$ 743</td>
<td>US$ 720</td>
</tr>
</tbody>
</table>

See notes to financial statements.

### 1. Description of Significant Accounting Policies and Business
We are a wholesale distributor of high-quality power tools, hand tools, electrical equipment, landscaping equipment, residential and commercial construction equipment, and paint products. The majority of our customers are smaller, independent hardware stores located in Saudi Arabia, the UAE, Egypt, and Lebanon.

**Allowance for Doubtful Accounts:** Our allowance for doubtful accounts is maintained to account for expected credit losses. Estimates of bad debts are based on individual customer risks and historical collection trends. Allowances are evaluated and updated when conditions occur that give rise to collection issues.

**Merchandise Inventory:** Merchandise inventory is presented at the lower of average cost or market. To present accurately the estimated net realizable value of the accounts, we adjust inventory balances when current and expected future market conditions, as well as recent and historical turnover trends, indicate adjustments are necessary.

### 5. Segment Reporting
The breakdown of revenues (in thousands) from different products is listed in the chart below:

<table>
<thead>
<tr>
<th>Segment Reporting</th>
<th>2012</th>
<th>2011</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hand Tools</td>
<td>21,463</td>
<td>19,684</td>
<td>19,403</td>
</tr>
<tr>
<td>Landscaping Equipment</td>
<td>14,309</td>
<td>15,645</td>
<td>13,494</td>
</tr>
<tr>
<td>Electrical Goods</td>
<td>17,170</td>
<td>15,849</td>
<td>11,042</td>
</tr>
<tr>
<td>Residential Construction Equipment</td>
<td>21,463</td>
<td>18,372</td>
<td>15,949</td>
</tr>
<tr>
<td>Commercial</td>
<td>11,447</td>
<td>10,498</td>
<td>9,815</td>
</tr>
<tr>
<td>Paint Products</td>
<td>25,755</td>
<td>23,621</td>
<td>26,991</td>
</tr>
</tbody>
</table>

### 6. Earnings Per Share
Earnings per share calculations for 2012, 2011, and 2010 were computed as follows:

- **Denominator** (shares of common stock): 5,000,000 (unchanged for all years)

Diluted earnings per share was the same as basic earnings per share for all years.
ACL is generalized audit software used by auditors to extract and analyze data on client’s computerized systems. Generalized audit software is discussed on pages 382–384 of the text.

The ACL Problems included in selected chapters (Chapters 7, 8, 11, 12, 14, and 16) are intended to provide you with an introduction to ACL. An in-depth study of its use is beyond the scope of most first auditing courses. The guidance provided in this Appendix is intended only to help you solve the problems in the text.

Software Installation

The software should be installed on your personal computer. For any other installation, see your instructor.

1. Insert the CD in the CD holder on your computer.
2. On the opening screen, select ‘Install’ and select the ‘ACL 9 Educational Edition.’ Proceed through the prompts to completion.
   • You must accept the license agreement to complete the installation
   • Select complete setup
   • Exit after the installation is complete

Opening ACL

An icon to open the ACL Education Edition should be on your desktop after installation. If it does not appear, then go to Windows Start and select ‘Programs’ to then locate the ACL Desktop Education Edition link. Select the ‘ACL Desktop Education Edition’ to launch the software.

Finding Companies, Tables, and Using Commands

The main screen Welcome to ACL should appear when you open ACL. Look at that screen now.

On that screen, you will see a header ‘ACL Projects.’ Click on the link for ‘Open an existing project.’ You will then see a list of four projects. The ACL assignments in the text use only two of these projects: ACL_Demo and Sample_Project. Both of these projects have several files, which ACL calls tables. You will first click on a project to identify the tables, which will appear in the left side of your screen window once you click on the project folder. (Note: When you open ACL again, any projects you have accessed will appear under “Recent Projects” and can be accessed using those links.)

Note: From now on, when you see italics it means you should use your computer to follow an instruction. The arrow sign (→) indicates an additional action to be taken.

Click Sample_Project to open the tables under Sample_Project → Click the plus sign next to the yellow tables folder → Click the plus sign next to the yellow accounts payable subfolder.
Appendix 5.

3. The Expression box is where you build filters using the available fields in the theses in that problem.

2. You will use the remainder of this material to help you answer the assigned questions in the text. The first three functions (Quick Sort, Filters, and Computed Fields) are not considered ACL commands. The remaining functions included here are all ACL commands. You will use those commands in ACL homework problems that are included in selected chapters. The descriptions below provide a brief overview of the functions that will be used to complete those problems. Within each ACL homework problem in the text, you will see the commands needed to answer the problem listed within parentheses in that problem.

Quick Sort Used to sort data in any field, either from lowest to highest or vice versa.

1. Click on the column heading of the field you want to sort.
2. Right click using your mouse to find the ﬂow Sort Ascending or Quick Sort Descending (you can right click Quick Sort Off to undo the sort).

Filters Used to ask questions of data in a table without adding a new field.

1. Click the Edit View Filter button in an open table to enter the Edit View Filter window.
2. Use the Expression box to build an expression.
3. The Expression box is where you build filters using the available fields in the current table, as well as the operators (\={!, <, >, AND, etc.). There are three components to a filter: (1) field, (2) operator, and (3) a numeric value, character value, or date.
4. In the Available Fields portion of the window, double-click the name of the field for which you are building a filter. Notice that the field name is inserted in the Expression box.
5. Use the operator buttons (\={!, +, -, >, etc.) and the numeric keypad on the keyboard to build the filter. Note: If you are performing a recalculation to determine if the original calculation already in the data table is correct, use < > as the operator with no spaces between the less than and greater than signs.

6. Enter an appropriate string or value after the operator. Use the following guidelines:

- Numeric values—enter as a number with no commas or dollar signs. For example, enter US$1,000,000, type 1000.
- Character values—enclose with one or two quotations. For example, to enter department D10, type ‘D10’ or D10. Use the same case as is used in the data field.
- Dates—click on the Date button located just below the mathematical operators to open the Date Selector box. Click the drop-down arrow to enter the monthly calendar box. Select the date, then click OK.

7. For more complex filters, use the AND, OR, OR NOT operators and repeat the preceding process for each portion of the filter. After selecting an AND, OR, OR NOT, it is necessary to repeat all three components (1) field, (2) operator, and (3) a numeric value, character value, or date) of the filter.

8. An example of an expression to select all invoices from transaction type IV with invoice dates equal to or before 31/12/2007 is as follows:

\[\text{TXN\_TYPE} = \text{‘IV’ AND INVDATE} < = \text{‘20071231’}\]

9. Click OK to complete the filter.

10. If you want to change the filter, click again to return to the Edit View Filter window. Make changes in the filter and click OK.

11. You can also apply additional commands to a filtered table until you remove the filter.

12. Click the Remove Filter button after you have completed all additional tests on the filtered table to return to the unfiltered table.

Computed Fields Used to ask questions of data in a table by adding a new field. The new field is derived from calculations using other fields in the table.

1. Click Edit to Table Layout to open the Layout Options window.
2. Select the Edit Fields/Expressions tab folder on the top row of the Layout window.
3. Click the Add a New Expression button, which is the third button down on the left side of the window under the ‘Edit Fields/Expressions’ tab. (You may need to expand the window to see the button)
4. Add a name for the computed field in the Name box that describes the new column. Also add a column title in the Alternative Column Title box, which will appear in the Table after you complete the new field.
5. Click the Expression button, which is located to the right of the Name box to open the Expression box.
6. Build an expression in the Expression box in the same way as for filters.
7. After building the expression, click OK to return to the original tables window.
8. Click the Accept Entry button on the top left of the screen to save the new computed field.
9. The new field can be added to the table view by completing the following steps:
   • Close the Edit Fields/Expressions window if it is still open.
   • Return to the data table which contains all the data for the file you are examining. Place the cursor in the column heading to the right of where you want the new computed field to appear in the table view.
   • Right click and then Click Add Columns from the drop-down menu.
   • Double-click on the name of the new computed field you just created.
   • Click OK. The new computed field now appears in the table view.
Absence of causal connection | عدم وجود علاقة السببية
An auditor's legal defense under which the auditor contends that the damages claimed by the client were not brought about by any act of the auditor.

Acceptable audit risk | خطر المراجعة أو التدقيق المقبول
A measure of how willing the auditor is to accept that the financial statements may be materially misstated after the audit is completed and an unmodified audit opinion has been issued; see also Audit assurance.

Acceptable risk of assessing control risk too low (ARACR) | الخطر المقبول لتقييم خطر الرقابة في مستوى منخفض
The risk that the auditor is willing to take of accepting a control as effective or a rate of monetary misstatements as tolerable when the true population exception rate is greater than the tolerable exception rate.

Acceptable risk of incorrect acceptance (ARIA) | الخطر المقبول للرفض غير الصحيح للمعلومات
The risk that the auditor is willing to take of accepting a balance as correct when the true misstatement in the balance is equal to or greater than tolerable misstatement.

Acceptable risk of incorrect rejection (ARIR) | الخطر المقبول لتقييم خطر الرقابة في مستوى منخفض
The risk that the auditor is willing to take of rejecting a balance as incorrect when it is not misstated by a material amount.

Accounting | المحاسبة
The recording, classifying, and summarizing of economic events in a logical manner for the purpose of providing financial information for decision making.

Accounting records | مستندات المحاسبة
The records of initial entries and other supporting documents such as invoices, cheques, fund transfers, contracts, minutes of meetings, reconciliations, and disclosures.

Accounts payable master file | أسطاذ مساعدة حسابات دائنة
A computer file for maintaining a record for each vendor of individual acquisitions, cash disbursements, acquisition returns and allowances, and vendor balances.

Accounts payable trial balance | ميزان مراجعة فرعى للحسابات الدائنة
A listing of the amount owed to each vendor at a point in time; prepared directly from the accounts payable master file.

Accounts receivable balance-related audit objectives | أهداف مراجعة ارصدة الحسابات المدينة
The seven specific audit objectives used by the auditor to decide the appropriate audit evidence for accounts receivable.

Acceptable liabilities | الخصوم أو الالتزامات المستحقة
Estimated unpaid obligations for services or benefits that have been received prior to the balance sheet date; common accrued liabilities include accrued commissions, accrued income taxes, accrued payroll, and accrued rent.

Accrued payroll expenses | مصاريف المرتبات المستحقة
The liability accounts associated with payroll; these include accounts for accrued salaries and wages, accrued commissions, accrued bonuses, accrued benefits, and accrued payroll taxes.

Acquisition and payment cycle | دورة الشراء والسداد
The transaction cycle that includes the acquisition of and payment for goods and services from suppliers outside the organization.

Adverse opinion | الرأي المعارض
A report issued when the auditor believes the financial statements are so materially misstated or misleading as a whole that they do not present fairly the entity's financial position or the results of its operations and cash flows in conformity with IFRS.

Aged trial balance | ميزان المراجعة تحليل أمور الديبو
A listing of the balances in the accounts receivable master file at the balance sheet date broken down according to the amount of time passed between the date of sale and the balance sheet date.

Agreed-upon procedures engagement | الإجراءات المتفق عليها
An engagement in which the procedures to be performed are agreed upon by the auditor, the responsible party making the assertions, and the intended users of the auditor's report; the auditor’s report is presented in the form of a negative assurance.

AICPA | الجمعية الأمريكية للمحاسبين القانونيين
American Institute of Certified Public Accountants, a voluntary organization of CPAs that sets professional requirements, conducts research, and publishes materials relevant to accounting, auditing, management consulting services, and taxes.

Allocation | التخصيص
The division of certain expenses, such as depreciation and manufacturing overhead, among several expense accounts.

Allocation of the preliminary judgment about materiality | توزيع التقدير المبدئي للأهمية النسبية
The process of assigning to each balance sheet account the misstatement amount considered to be material for that account based on the auditor’s preliminary judgment.

Alternative audit procedures | إجراءات المراجعة البديلة
The follow-up of a positive confirmation not returned by the debtor with the use of documentation evidence to determine whether the recorded receivables exist.

Analytical (Audit) procedures | إجراءات المراجعة البديلة
Use of comparisons and relationships to assess whether account balances or other data appear reasonable.
Analytical procedures | استخدام الإجراءات التحليلية للتحقق من صحة الأرصدة أو البيانات الأخرى.

Use of comparisons and relationships to assess whether account balances or other data appear reasonable.

Audit evidence | أدلة التدقيق:
Any information used by the auditor to determine whether the information being audited is stated in accordance with established criteria.

Audit procedures resulting from the auditor's decisions about the audit of historical financial statements include sample sizes, items to select, and timing of the tests.

Assurance services | خدمات التأكيد:
A type of assurance service in which the CPA firm issues a written statement reporting whether the financial statements are in material conformity with accounting standards.

Audit of historical financial statements | تقديم التدقيق حول الأرصدة التاريخية:
A form of attestation service in which the auditor issues a written report stating whether the financial statements are in material conformity with accounting standards.

Audit risk | مخاطر التدقيق:
The risk that the client will fail to achieve its objectives related to financial reporting.

The risk that the auditor will conclude after conducting an adequate audit that the financial statements are fairly stated and an unqualified opinion can therefore be issued when, in fact, they are materially misstated.

Audit risk model | موديل مخاطر التدقيق:
A formal model reflecting the relationships between acceptable audit risk (AAR), inherent risk (IR), control risk (CR), and planned detection risk (PDR).

Audit sampling | عينة التدقيق:
The principal record of how 90 percent of a population for the purpose of making inferences about that population.

Audit strategy | خطة التدقيق:
Overall approach to the audit that considers the nature of the client, risks of significant misstatements, and other factors such as the number of client locations and past effectiveness of client controls.

Auditing | التدقيق:
The accumulation of evidence about information to determine and report on the degree of correspondence between the information and established criteria.

Auditing around the computer | التدقيق عبر الحاسب:
Auditing without relying on and testing automated controls embedded in computer application programs, which is acceptable when the auditor has access to readable source documents that can be reconciled to detailed listings of output or when sufficient nonautomated controls exist.

Auditing through the computer | التدقيق عبر الحاسب:
Auditing by testing automated internal controls and account balances electronically, generally because strong general controls exist.

Bank confirmation | الذين يحصلون على المبالغ:
A form through which the bank responds to the auditor about bank balance and loan information provided on the confirmation.

Bank reconciliation | التذكير بالأفراد:
The monthly reconciliation, usually prepared by client personnel, of the differences between the cash balance recorded in the general ledger and the amount in the bank account.

Block sample selection | مكتبة العينات:
A nonprobabilistic method of sample selection in which items are selected in measured sequences.

Board of Directors | مجلس الإدارة:
Persons elected by the entity’s shareholders to manage, direct, and monitor the affairs of the company.

Branch bank accounts | حسابات بنكية:
Separate bank accounts maintained at local banks by branches of a company.

Budgets | الميزانية:
Written records of the client’s expectations for the period; a comparison of budgets with actual results may indicate whether or not misstatements are likely.

Business failure | الفشل في الأعمال:
The situation when a business is unable to repay its lenders or meet the expectations of its investors because of economic or business conditions.

Business functions for the sales and collection cycle | المهام بين التسويق والشحن:
The key activities that an organization must complete to execute and record business transactions for sales, receipts, sales returns and allowances, write-off of uncollectible accounts, and bad debt expense.

Capital acquisition and repayment cycle | الدورة الحصول على رأس المال والمدفو عات الخاصة به:
The transaction cycle that involves the acquisition of capital resources in the form of interest-bearing debt and owners’ equity, and the repayment of the capital.

Capital stock certificate record | البقرة والبخاخ:
A record of the issuance and repurchase of capital stock for the life of the corporation.

Cash equivalents | الأموال المتاحة:
Excess cash invested in short-term, highly liquid investments such as time deposits, certificates of deposit, and money market funds.

Certified public accountant | المحترف المالي:
A person who has met the country’s regulatory requirements, including passing the Uniform CPA Examination, and has thus been certified; a CPA may have as his or her primary responsibility the performance of the audit function on published historical financial statements of commercial and noncommercial financial entities.

Certified public accountant | محترف المالي:
A person who has met the country’s regulatory requirements, including passing the Uniform CPA Examination, and has thus been certified; a CPA may have as his or her primary responsibility the performance of the audit function on published historical financial statements of commercial and noncommercial financial entities.

Chart of accounts | نمط الأعمال:
A listing of all the entity’s accounts, which classifies transactions into individual balance sheet and income statement accounts.

Classes of transactions in the sales and collection cycle | الدورات:
The categories of transactions for the sales and collection cycle in a typical company: sales, cash receipts, sales returns and allowances, write-off of uncollectible accounts, and bad debt expense.

Client business risk | مخاطر الأعمال:
The risk that the client will fail to achieve its objectives related to financial reporting, (2) effectiveness and efficiency of operations, and (3) compliance with laws and regulations.

Close family | العائلة:
A parent, child, or sibling who is not an immediate family member.

Closely held corporation | الشركة المساهمة:
Corporation with stock that is not publicly traded; typically, there are only a few shareholders and few, if any, capital stock account transactions during the year.

Collusion | التآمر:
A cooperative effort among employees to steal assets or misstate records.

Commitments | التزامات:
Agreements that the entity will hold to a fixed set of conditions, such as the purchase or sale of merchandise at a stated price, at a future date, regardless of what happens to profits or to the economy as a whole.
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ACL Education Edition

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