Topic 11: Auditing Sales and Receivables

- Sales and receivables face a risk of overstatement

Explain functions of the sales cycle (from a biz perspective)

When a sale happens, this occurs:

- At sale,
    - DR A/R (Assets)
        - CR Sales (Revenue)
- At payment,
    - DR Cash (Assets)
        - CR A/R (Assets)
- The only difference between a cash sale and a credit sale is the timing.
- There are 2 parts to a cycle function – the point of sale and the point where cash is collected.

3 different types of transactions

- 1. <u>Sales Transactions</u> – rld to the sale of goods and services to outside entities that could include PPE or repair service
- 2. <u>Receipt Transactions</u> – rld to cash receipts for such goods and services
- 3. <u>Adjustments</u> – e.g. returns, allowance (trade discounts), bad debts

Tips:
Issues to understand concepts for:
- Depreciation
- Inventory valuation
- Acc receivables valuation
- Impairments
- Valuations
- Tax effect accounting
- Consolidation – big picture of corporate performance
- Takeover acquisitions
- Revenue recognition

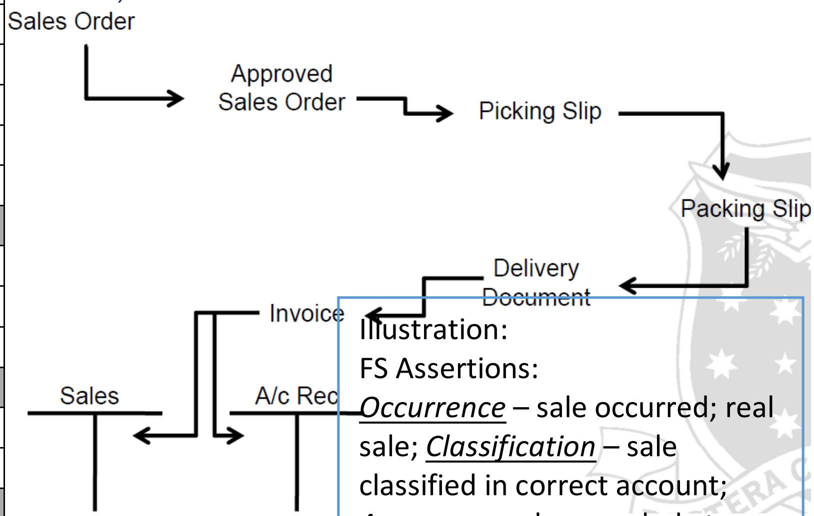
** <u>Usual problem is answering with generic answers – lack depth and specific knowledge</u>
Consider:
- What is indicated in the question?
- How plausible is it in the scenario given?
- Is there a trigger for the problem?

Exam tips: Understand the question before doing anything

Sales Cycle Functions

Sales Cycle Functions	
Sales Transactions	Accepting customer orders
	Approving credit
	Filling and dispatching orders
	Invoicing customers
	Recording the sales
Receipt Transactions	Receiving cash
	Depositing cash in bank
	Recording receipts
Adjustments	Sales returns and allowances
	Bad and Doubtful debts

Sales Cycle



- Cash sales where most of these will occur at the same time
- Impact to financial statement only occurs at the end of the sales cycle
- However, some processes may be omitted, could it be due to gaps in the process?
- Are there extra steps in this process? (usually internal controls would be the extra steps)
- Who are the sales made to?
- What are they selling?

Illustration:
FS Assertions:
<u>Occurrence</u> – sale occurred; real sale; *<u>Classification</u>* – sale classified in correct account; *<u>Accuracy</u>* – sale recorded at right amount; accurate; *<u>Cut-off</u>* – sale recorded in correct period
- Get sufficient appropriate evidence to satisfy ourselves that what client has recorded reflects the actual economic situation. Errors may occur eg recorded wrongly or missing items

    - High transaction **volume**, use <u>lower assessed level of control risk approach</u> – more efficient for purchases and cash payment transactions
    - Low transaction volume, use <u>predominantly substantive approach</u>

A mix of Tests of Control and Substantive tests to be applied, depends on IR and CR assessment and materiality

- Materiality
    - <u>Purchases transactions are significant in most organisations</u>
    - <u>A/P balance nearly always material</u> – because most COYs buy on credit
    - Consider 'significant transactions' in a service organisation – "purchase" of staff time
        - E.g. PwC purchase significant employees' time but it is usually a separate procedure, a separate system

Design appropriate tests of controls and substantive procedures for purchases and payables

Tests of Control

- Based on client's internal controls
- Preliminary assessment of CR
- Audit procedures – to test the controls
    - Nature
        - **Enquire**
        - **Observe**
        - **Inspect**
        - **Re-perform**
    - Timing
        - Interim work
        - Test for whole period
    - Extent
        - Enquire more than 1 person
        - More extensive inspection of documents
        - More evidence needed to support Lower Assessed Control Risk Approach
- If testing of controls reveals that controls are not as good as we thought, we need to go back and change audit strategy → increase substantive testing because you need to get evidence some other way.

Substantive Procedures

Initial Procedures

- Tracing CY's opening balance to PY's closing balance in prior year's working paper
- Review activity in GL account for payables, and investigate entries that appear unusual in amount or source

Analytical Procedures

- Review significant changes
- Use financial and non-financial information

Tests of Details of Transactions

- Vouch a sample of recorded creditor transactions to supporting documentation
- Vouch credits to supporting invoices, receiving reports, PO or other documents
- Vouch debts to payments
- Trace from source documents to general ledger account
- Check payments between balance date and the end of fieldwork (*Cut-off*)

- A material and pervasive financial report is useless for the FS users – no real value for them.

Modified opinion

- When a modified opinion is issued by the auditor, the auditor's report shall include a paragraph that provides a description of the matter giving rise to the modification. This paragraph should be placed immediately before the opinion paragraph and to use the heading "Basis for Qualified Opinion", "Basis for Adverse Opinion", or "Basis for Disclaimer of Opinion", as appropriate
- Basically, a modified opinion requires a description of why it is being modified

Explain other reporting considerations for reporting entities

Emphasis of Matter paragraph

- For including something significant that the auditor wants to draw users' attention to irrespective of the audit opinion
    - E.g. an uncertainty relating to the future outcome of exceptional litigation or regulatory action, major catastrophe that has had, or continue to have a significant effect on the entity's financial position
- Impt to note that the emphasis of matter para does not amount to a modification

Exam tips:
- Understand the idea of subsequent events
- If you must consider the issue, state how the accountant has treated it – appropriately or not? Should it be an adjusting or non-adjusting event?
- If inappropriate, how will this information impact the audit opinion – look at 2 reasons why auditor would modify audit opinion.