

CHAPTER 6

The Why and How of Auditing Receivables/Revenue

Revenues are the lifeblood of any organization. Without cash inflows, the entity may cease to exist. So, it's important that businesses generate sales or some type of revenue.

For you, the auditor, it's important to verify revenue and related receivables. Why? Because some companies manipulate their earnings by inflating their receivables. When trade receivables increase, revenues increase. A company can fraudulently increase its net income by recording nonexistent or inflated receivables.

In this chapter, we'll answer questions such as, "Should I confirm receivables or examine subsequent receipts?" and "Why should I assume that revenues are overstated?"

Auditing Receivable and Revenues — An Overview

In this chapter, we will cover the following:

- Primary accounts receivable and revenue assertions
- Accounts receivable and revenue walkthrough
- Directional risk for accounts receivable and revenues
- Primary risks for accounts receivable and revenues
- Common accounts receivable and revenue control deficiencies
- Risk of material misstatement for accounts receivable and revenues
- Substantive procedures for accounts receivable and revenues
- Common accounts receivable and revenue work papers

Primary Accounts Receivable and Revenue Assertions

First, let's look at assertions. The primary relevant accounts receivable and revenue assertions include:

- Existence and occurrence
- Completeness
- Accuracy
- Valuation
- Cutoff

Of these assertions, I believe—in general—existence of receivables, occurrence of revenues, cutoff of receivables and revenues, and valuation of receivables are most important. Clients assert that receivables exist, that receivables and revenues are recorded in the right period, that revenues occurred, and that receivables are properly valued. Additionally, accuracy comes into play if the customer has complex receivable transactions. Though usually less of a risk, the completeness assertion can be relevant when a company fails to properly record its receivables.

Accounts Receivable and Revenue Walkthrough

Second, perform your risk assessment work in light of the potential relevant assertions. In performing accounts receivable and revenue walkthroughs, ask questions such as:

- Are receivable subsidiary ledgers reconciled to the general ledger?
- Is a consistent allowance methodology used?
- What method is used to compute the allowance and is it reasonable?
- Who records and approves the allowance?
- Who reviews aged receivables?
- What controls ensure that revenues are recorded in the right period?
- Is there proper segregation of duties between persons

recording, billing, and collecting payments? Who reconciles the related records?

- What software is used to track billings and collections?
- Are there any decentralized collection locations?
- When are revenues recognized and is the recognition in accordance with the reporting framework?
- What receivables and revenue reports are provided to the owners or the governing body?

As we ask questions, we also inspect documents (e.g., aged receivable reports) and make observations (e.g., who collects the payments).

If control weaknesses exist, we create audit procedures to respond to them. For example, if—during the walkthrough—we see inconsistent allowance methods, we will perform more substantive work in relation to the allowance account.

Directional Risk for Accounts Receivable and Revenues

Third, consider the directional risk of accounts receivable and revenues. The directional risk for accounts receivable and revenue is that they are overstated. In performing your audit procedures, ensure that accounts receivables and revenues are not overstated. For example, review the cutoff procedures. Be sure that no subsequent period revenues are recorded in the current fiscal year.

Audit standards require that auditors review estimates for management bias. So, consider the current year allowance and bad debt write-offs in light of the prior year allowance. This retrospective review allows the auditor to see if the estimate is biased. There is a threat that management might reduce allowances to inflate earnings.

Moreover, the audit standards state there is a presumption (unless rebutted) that revenues are overstated. Therefore, we are to assume revenues are overstated, unless we can explain why they are not.

Primary Risks for Accounts Receivable and Revenues

Fourth, think about the risks related to receivables and revenues.

The main risks include:

- An intentional overstatement of accounts receivable and revenue
- Theft of collections
- Overstated accounts receivable and revenue due to improper cutoff
- Understated allowances
- Inconsistent or improper revenue recognition

Risks related to revenue vary from company to company. For example, one telecommunications company might sell bundled services while another may not. Revenue recognition is more complex (risky) for the company selling bundled services.

Also, risk related to revenue varies from industry to industry. For example, the allowance for uncollectible is a high risk area for healthcare entities, but may not be in other industries.

Common Accounts Receivable and Revenue Control Deficiencies

Fifth, think about the control deficiencies noted during your walkthroughs and other risk assessment work.

In smaller entities, the following control deficiencies are common:

- One person performs two or more of the following:
 - Bills customers
 - Receipts monies
 - Makes deposits
 - Records those payments, and
 - Reconciles the related bank account

- The person computing allowances doesn't possess sufficient knowledge to do so
- No surprise audits of receivables and revenues
- Multiple people work from one cash drawer
- Receipts are not appropriately issued
- Receipts are not reconciled to daily collections
- Daily receipts are not reviewed by a second person
- No one reconciles subsidiary receivable ledgers to the general ledger
- Individuals with the ability to adjust customer receivable accounts also collect cash (and a second person is not monitoring adjustments)
- Inconsistent bad debt recognition with no second-person review
- The revenue recognition policy may not be clear and may not be in accordance with the reporting framework

Risk of Material Misstatement for Accounts Receivable and Revenues

Sixth, assess your risks of material misstatement in light of the information you've gathered.

The assertions that concern me the most are existence, cutoff, occurrence, and valuation. So my RMM for these assertions is usually moderate to high.

My response to higher risk assessments is to perform certain substantive procedures: namely, receivable confirmations and tests of subsequent collections. As RMM increases, I send more confirmations and examine more subsequent collections.

Additionally, I thoroughly test management's allowance computation. I pay particular attention to uncollected amounts beyond 90 days. Uncollected amounts beyond 90 days should usually be heavily reserved. And amounts beyond 120 days should—in most cases—be fully reserved.

Substantive Procedures for Accounts Receivable and Revenues

And finally, it's time to determine your substantive procedures in light of your identified risks.

My customary audit procedures are as follows:

- Confirm accounts receivable balances (especially larger amounts)
- Vouch subsequent period collections, making sure the subsequent collections relate to the period-end balances (sampling can be used)
- Review allowance computations to see if they are consistent with prior years, compare allowance percentages to industry averages, agree the allowance to supporting documentation (e.g., histories of uncollectible amounts), and recompute the related numbers
- Compare all significant revenue accounts with historical data (three or more years if possible)
- Create summaries of average customer income (e.g., total revenue by category divided by the number of customers) and compare with prior periods
- Compute average profit margins by sales categories and compare with previous years

If you identify a risk of theft, perform related substantive procedures. For example, you might examine write-offs of receivables for employees that handle cash.

Controls can be tested for billing, collection, and posting. If controls are effective, then some substantive procedures may not be necessary.

Common Accounts Receivable and Revenue Work Papers

My accounts receivable and revenue work papers usually include the following:

- An understanding of accounts receivable and revenue-related internal controls
- Risk assessment of accounts receivable and revenue at the assertion level
- Documentation of any control deficiencies
- Accounts receivable and revenue audit program
- An aged receivables detail at period-end
- Copies of receivable confirmations
- A summary of confirmations received
- Subsequent collection work papers
- Allowance work paper
- Revenue comparison work papers
- Disclosure checklist

Auditing Receivables/Revenue - A Simple Summary

- Primary relevant receivable/revenue assertions include existence of receivables, cutoff of receivables and revenues, occurrence of revenues, and valuation of receivables
- Perform a walkthrough of the receivables/revenue cycle by making inquiries, inspecting documents, and making observations
- The directional risk for receivables and revenue is that they are overstated
- Primary risks for receivables and revenues include:
 - An intentional overstatement of accounts receivable and revenue
 - Theft of collections
 - Overstated accounts receivable and revenue due to improper cutoff
 - Understated allowances

- Inconsistent or improper revenue recognition
- The substantive procedures for receivables and revenue should be responsive to the identified risks. Common procedures include:
 - Confirmation of accounts receivable balances
 - Vouching subsequent period collections
 - Reviewing allowance computations to see if they are consistent with prior years and appropriate for the current year
 - Comparing all significant revenue accounts with historical data
 - Creating summaries of average customer income (e.g., total revenue by category divided by the number of customers) and comparing with prior years
 - Computing average profit margins by sales categories and comparing with previous years
 - Fraud-related procedures such as examining write-offs of receivables for employees handling cash

Now you know how to audit receivables and revenues.

Next, we'll see how to audit investments.