**Chapter-Two**

**Audit of Accounts Receivables and Sales**

**2.1. Sources and nature of accounts receivables**

Receivables-included not only claim against customers arising from the sale of goods or services, but also a variety of miscellaneous claims such as loans to officers or employee, loans to subsidiaries, claims against various other firms, claims for tax refunds, and advances given to suppliers

In the financial statements of most of the companies, accounts receivables and notes receivables are relatively large in amounts and auditors need to have more concern about the audit of these items during the course of audit. Auditors need to have a special attention to the presentation and disclosure of the loans to the officers, directors and subsidiary companies, as these related party transactions may benefit only the borrower rather than the lending company.

**2.2. Auditors’ Objectives in auditing account receivables and sales**

The auditor’s objectives in the audit of accounts receivables and sales are:

1. Consider the internal control over accounts receivables and sales transactions
2. Substantiate the existence of the accounts receivables and occurrence of sales transactions
3. Establish the completeness of the accounts receivables and sales
4. Determine that the client has the rights to the recorded receivables
5. Establish the clerical accuracy of the records and supporting schedules of accounts receivables and sales
6. Determine the valuation of receivables and sales is at appropriate net realizable value
7. Determine that the presentation and disclosure of receivables and revenues are adequate including the separation of receivables into appropriate categories, adequate reporting of any receivables pledged, and collateral, and disclosure of related-party sales and receivables

**2.3. Internal control over sales transactions and receivables**

**2.3.1. Internal control over sales transactions**

If the internal control over credit sales is ineffective, it may cause business much because the major revenue for the organization arises from sales only. Hence the auditor has to study and evaluate the internal control relating to the sales. This helps the auditor in determining the nature, timing and extent of his substantive procedures. Before studying and evaluating the internal control relating sales the auditor should have sufficient understanding about the business of the client. This will help the auditor in assessing the extent to which the sales transactions of the client’s business will affect the misstatement. If the internal control procedures are not satisfactory, the auditor can apply additional tests or modify the procedures according to the circumstances. The internal control relating to sales can be studied and evaluated by dividing the sales cycle into the following four segments

1. **Processing orders and dispatching goods** 
   1. Does the company maintain a standard price list and if sales are done at a lower price whether proper authorization is received.
   2. Does the system allows for rebates and discount and if so is it with proper authorization.
   3. What are the procedures for related party transactions?
   4. Are the sales invoices are prenumbered?
   5. What are the procedures for fixing credit limits for the customers?
   6. Is a copy of the sales invoice is sent to the dispatch department and the accounting department?
   7. Is the dispatch documents prenumbered?
   8. Is the copy of the dispatch documents sent to the customer and to the accounting department?
   9. Does the customer or his agent obtain an acknowledgement for the receipt of goods?
   10. Whether dispatch documents are prepared at the time of dispatch of merchandise
   11. Whether the dispatch documents are prenumbered
2. **Billing of customers and recoding of sales** 
   1. Whether the sales invoices are prepared on receipt of dispatched documents.
   2. Whether the sales invoice contain all the relevant details including name of the customer, the quantity, price, freight, insurance, tax, etc.,
   3. Whether the sales invoices are properly checked and authorized before dispatch.
   4. Whether the original invoice is sent directly to the customer.
   5. Whether the accounting entries are made on a timely basis.
   6. Whether the dispatch documents the railway receipt or the transporter’s receipts or the bill of lading is attached with the sales invoice.
   7. Whether the sales invoice is prenumbered?
3. **Processing and recoding of receipts**

(This has already been discussed in chapter – 1 Audit of Cash Transactions.)

1. **Follow up on sales**
   1. After sales service
      1. What is the nature of after sales service?
      2. Whether the company maintains adequate records of after sales service?
      3. Whether the service engineers required filling up any form after the service or visiting along with the signature of the customers?
      4. Whether the service engineers authorized to collect cash and issue receipts provisionally.
      5. Whether the periodic comparison of cost of parts replaced free of charge with the budgeted figures.
   2. **Sales Returns**
      1. Whether the goods returned are accepted with proper authority
      2. Whether inward return note is prepared or not
      3. Whether inward return note are prenumbered
      4. Whether returned goods are sent to the store immediately
      5. Whether credit note is prepared on the basis of inward return note.
      6. Whether credit note is prenumbered
      7. Whether the sales commission paid with respect to the goods returned are recovered
      8. Whether the reason for return are analyzed.

### 2.3.2. Substantive procedures for sales transactions

## Tests of individual transactions

1. Examine the sales summary regarding name, date, amount, quantity, discount, calculation etc.
2. Select sample of invoices and check in detail- audit in depth for approval of granting credit, price, discount, dispatch of goods, entry in the inventory records, entries in the customer accounts etc
3. Examine the numerical sequence of the sales order, outward challan etc
4. Examine the arithmetical accuracy of the sales book
5. Examine the entries in the sales return book
6. Examine the copies of the credit note
7. Examine the numerical sequence
8. Check the year end or the cut off transactions
9. Examine the payment made by the customers
10. Examine whether GAAP is followed in recognition of revenue

## Analytical procedures

1. Compare the sales figures of different months or quarters of the current year and enquire into any unusual fluctuations
2. Prepare a statement showing the quantities of the beginning inventory plus purchases made and minus the sales made during the year and the result will give the ending inventory. If there is any negative figure will disclose the manipulations if any
3. Compare the budgeted sales with the actual sales for the current year
4. Compare the current year’s total sales as well as sales of different months or quarters with the corresponding figures of the previous year.
5. Compare the ratio of value of sales of each major product of the total sales for the current year with the corresponding figures for the previous years
6. Compare the gross profit ratio for the current year with the corresponding gross profit ratio of the previous years and with the industry average

## Examination of presentation and disclosure

The auditor has to verify whether the sales have been properly classified and disclosed under appropriate heads in the financial statements in accordance with the generally accepted accounting principles

**2.3.3. Internal control over accounts receivables**

The auditor has to verify the internal control system regarding the accounts receivable and examine

1. Whether the basis for determining the credit limit is satisfactory
2. Whether the credit limit is reviewed periodically
3. Whether the credit limit is approved by an appropriate official
4. Whether the processing orders, dispatch of goods, billing, receiving and recording of realizations and follow up of sales are effective
5. Whether the accounts receivables are remaining unpaid beyond normal period and if remaining whether suitable actions has been taken or not
6. Whether a statement of account is sent to all accounts receivables periodically
7. Whether confirmations of balances are made
8. Whether adjustments such as discounts, sales returns etc are approved by an authorized officer
9. Whether the uncollectible expenses are properly written off
10. Whether the general ledger is in agreement with the subsidiary ledgers

### 2.3.4. Substantive tests for accounts receivables

The auditor has to apply the following substantive tests for accounts receivables

1. Examination of individual accounts
2. Examination of realization from customers
3. Identification of bad debts
4. Confirmation of accounts
5. Examination of presentation and disclosure

### 2.4. Audit program for receivables and sales transactions

The most appropriate procedures for a particular audit will be guided by the nature of the internal controls in force and by other circumstances of the engagement. The following are the audit program for the verification of receivables and sales transactions.

**A. Consider the internal control for receivables and sales transactions**

**1.** *Obtain an understanding of internal control over receivables and sales transactions*.

To do so, auditors may prepare a written description or flow chart and complete internal control questionnaire for revenues and receivables. Some of the questions that might be asked include:

* Are orders from customers initiated and reviewed by sales department?
* Are sales invoices prenumbered and all numbers accounted for?
* Are all sales approved by the credit department before shipment?
* Are estimates of revenues performed by competent personnel using appropriate method?
* Are all polices and procedures indicated in the flow-chart being used in the operation?

As auditors confirm their understanding of the revenues cycle, they will observe:

* Whether there is appropriate segregation of duties
* Review revenue budget and follow up on the variance
* Perform a work through of the cycle; inspect various documents such as bills of lading, sales invoice, and customers statements

After auditors have obtained an understanding of the controls relating to receivables and sales, they will consider the types of misstatements of the accounts that may occur.

**2.** *Asses control risk and design additional tests of controls for receivables and sales*. Based on the understanding of the client’s internal controls over receivables, the auditors develop their planned level of assessed control risk for the various financial statements assertions. If auditors need to obtain additional evidences about operating effectiveness of the client’s controls, they may design additional tests of controls.

**3.** *Perform additional tests of controls for those controls which the auditors plan to consider to support their planned assessed level of control risk, such as:*

**a)** Examine significant aspects of a sample of sales transactions by applying procedures such as:

* Compare customers purchase orders to the client’s sales order and then to duplicate copy of the sales invoice. The description and quantity should be the same on the three documents.
* See whether there is consistent pricing and sales discount policies
* Investigate the controls for sales to related parties (Effective control over inter-company or inter-branch transfers of merchandise often requires the same kind of formal billings, shipping and collection functions as for sales to outsiders.

**b)** Compare a sample of shipping documents to related sales invoices

To assure that all shipments are billed, the auditors may obtain a sample of shipping documents may obtain a sample of shipping documents issued during the year and compare these to sales invoice.

**c)** Review the uses and authorization of credit memorandum

- See whether all returns and allowances should be supported by credit memorandum.

-Review whether there is proper authorization of credit memorandum is practiced.

**d)** Reconcile selected cash register tapes and sales tickets with sales journals. For cash sales auditors may compare selected daily totals in the sales journals with cash register readings or tapes.

**e)** Test computer application controls if any. If the client company has established effective computer application controls for sales transactions, the auditors might decide to test these controls directly instead of testing a sample of sales transactions

1. Reassess control risk and modify substantive tests for receivables and sales transactions.

When auditors have completed the procedures described in the preceding sections, they should reassess the extent of control risk for each financial statements assertion regarding receivables and revenues.

**B. Perform substantive tests of receivables and sales transactions**

**The objective of major substantive testing procedures of Account receivables and revenue balances are given in the following table.**

|  |  |
| --- | --- |
| **Subjective Test** | **Primary audit objective to be addressed** |
| **5**.Obtain an aged trial balance of trade accounts receivables and analyses of other accounts receivable and reconcile to ledgers which helps to:  - Confirm the existence of the balances  - To check adequacy of estimate of credit-losses (doubtful expenses)  - To test footing, cross footing and aging  - To check balances of current and past due accounts Clerical accuracy  - For other related purposes.  **6.** Obtain analyses of notes receivables and related interests. The analyses of notes receivables supporting the general ledger control accounts may be prepared with regard to information such as name of the maker, date of issuance, maturity date, amounts | Clerical accuracy |
| **7.** Inspect notes on hand and confirm those with holders   * Make confirmation with client debtor for notes receivables that is with holders. * For discounted notes receivable make confirmation with the maker as to the naming of the maker, balance of the notes, the interest rate, due date and so on. | Existence, occurrence and Ownership right. |
| **8**. Confirm receivables with debtors through direct communication with the debtors. | Existence, occurrence, and Right; valuation. |
| **9**. Review the year end cut-off sales transactions (year end sales and collections) | Existence, occurrence right and completeness |
| 1. Perform analytical procedures for A/R, N/R, other Receivables and revenues. In this case, several ratio and relationships can be computed to indicate the overall reasonableness of the amounts of receivables, revenues e.g. Gross profit rate, the ratios of sales of last month or weak to total sales for the quarter or year and so, units shipped in relation to revenues and production records, the ratio of uncollectible accounts   expenses to credit sales and others.   1. Review significant year end contracts for unusual terms e.g. relaxed terms of sales near year end to boost level of sales which may affect collectability,test unusual pricing, billings, delivery, returns, exchange, and others | Existence, occurrence and right completeness |
| 1. Verify the interest earned on notes and accrued receivables by computing such as accrued interest receivable at the beginning of of the year, interest earned during the year,   interest collected during the year, and interest accrued at the end of the year. | Existence, occurrence, right, completeness |
| 1. Evaluate the propriety/ appropriateness/ of client’s accounting for transactions e.g. check the appropriateness of sales and receivables related transactions, recognition or revenues (point of sale, installments, percentage of completions) ,timing of customer billings and other related matters. 2. Evaluate accounting estimates related to receivables and revenues e.g. estimate of sales returns, percentages of completion, allowance for uncollectability, etc. 3. Determine adequacy of allowance for Uncollectablity accounts-for fair presentation the receivables should be presented in the balance sheet at net realizable values | Valuation |
| 1. Ascertain the existence of pledged receivables-if there is pledged receivables it should be adequately disclosed 2. Investigate receivables from related parties such as officers, stockholders, affiliates, branches, divisions, etc as to their legitimacy. 3. Evaluate financial statements presentation and disclosure   i.e appropriate presentation of A/R, N/R, interest receivables, loan receivables and disclosure in accordance with GAAP those pledged or collate red receivables | Presentation and disclosure. |