

- er file.
- g file.
- o (3) s' accounts receivable master file.
- o (4) oice file.\*

**OBJECTIVE 14-3** The Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued a report called *Fraudulent Financial Reporting: 1998-2007, An Update*. Download the report at [www.coso.org](http://www.coso.org) to answer the following questions. (Information on fraud techniques can be found on pp. 17–18 of the report):



- a. How many fraud companies were included in the report? What percentage of the frauds involved improper revenue recognition?
- b. What are the two broad categories of improper revenue recognition included in Table 9 of the report? What is the difference between the two types of improper revenue recognition?
- c. Review the specific techniques used to overstate revenue. Describe a conditional sale and a bill and hold sale.

**Required**

**14-29 (OBJECTIVES 14-3, 14-5)** The following are common audit procedures for tests of sales and cash receipts:

1. Examine the sales journal for related-party transactions, notes receivable, and other unusual items.
2. Select a sample of customer orders and trace the document to related shipping documents, sales invoices, and the accounts receivable master file for comparison of name, date, and amount.
3. Examine duplicate sales invoices for an indication that unit selling prices were compared to the approved price list.
4. Examine duplicate sales invoices to determine whether the account classification for sales has been included on the document.
5. Compare the quantity and description of items on duplicate sales invoices with related shipping documents.
6. Perform a proof of cash receipts.
7. Examine a sample of remittance advices for approval of cash discounts.
8. Account for a numerical sequence of remittance advices and determine whether there is a cross-reference mark for each one, indicating that it has been recorded in the cash receipts journal.
9. Trace recorded cash receipts in the accounts receivable master file to the cash receipts journal and compare the customer name, date, and amount of each one.

- a. Identify whether each audit procedure is a test of control or a substantive test of transactions.
- b. State which transaction-related audit objective(s) each of the audit procedures fulfills.
- c. For each test of control in part a., state a substantive test that could be used to determine whether there was a monetary misstatement.

**Required**

**14-30 (OBJECTIVE 14-5)** The following is a list of possible errors or fraud (1 through 5) involving cash receipts and controls (a. through g.) that may prevent or detect the errors or fraud:

**Possible Errors or Fraud**

1. Customer checks are properly credited to customer accounts and are properly deposited, but errors are made in recording receipts in the cash receipts journal.
2. Customer checks are misappropriated before being forwarded to the cashier for deposit.
3. Customer checks are received for less than the customers' full account balances, but the customers' full account balances are credited.
4. Customer checks are credited to incorrect customer accounts.
5. Different customer accounts are each credited for the same cash receipt.

\*Based on AICPA question paper, American Institute of Certified Public Accountants.

3. Receipts received in the mail are received by a secretary with no record-keeping responsibility.

4 (5). Receipts received in the mail are forwarded unopened with remittance advices attached.

Cash receipts journal is prepared by the treasurer's department.

Receipts are deposited weekly.

Statements are sent monthly to customers.

Write-offs of accounts receivable are approved by the controller.

The bank reconciliation is prepared by individuals independent of cash receipts record keeping.

a. For each of the preceding 1–10 items, indicate whether the item represents an:

A. Internal control strength for the sales and collection cycle.

B. Internal control deficiency for the sales and collection cycle.

b. For each item that you answered (A), indicate the transaction-related audit objective(s) to which the control relates.

c. For each item that you answered (B), indicate the nature of the deficiency.\*

Required

**14-33 (OBJECTIVE 14-3)** YourTeam.com is an online retailer of college and professional sports team memorabilia, such as hats, shirts, pennants, and other sports logo products. Consumers select the college or professional team from a pull-down menu on the company's Web site. For each listed team, the Web site provides a product description, picture, and price for all products sold online. Customers click on the product number of the items they wish to purchase. The following are internal controls YourTeam.com has established for its online sales:

1. Only products shown on the Web site can be purchased online. Other company products not shown on the Web site listing are unavailable for online sale.

2. The online sales system is linked to the perpetual inventory system, which verifies quantities on hand before processing the sale.

3. Before the sale is authorized, YourTeam.com obtains credit card authorization codes electronically from the credit card agency.

4. Online sales are rejected if the customer's shipping address does not match the credit card's billing address.

5. Before the sale is finalized, the online screen shows the product name, description, unit price, and total sales price for the online transaction. Customers must click on the Accept or Reject sales button to indicate approval or rejection of the online sale.

6. Once customers approve the online sale, the online sales system generates a Pending Sales file, which is an online data file that is used by warehouse personnel to process shipments. Online sales are not recorded in the sales journal until warehouse personnel enter the bill of lading number and date of shipment into the Pending Sales data file.

a. For each control, identify the transaction-related audit objective(s) being fulfilled if each control is in effect.

b. For each control, describe potential financial misstatements that could occur if the control was not present.

Required

**14-34 (OBJECTIVE 14-4)** The Meyers Pharmaceutical Company, a drug manufacturer, has the following internal controls for billing and recording accounts receivable:

CASE

1. An incoming customer's purchase order is received in the order department by a clerk who prepares a prenumbered company sales order form on which is inserted the pertinent information, such as the customer's name and address, customer's account number, quantity, and items ordered. After the sales order form has been prepared, the customer's purchase order is attached to it.

2. The sales order form is then passed to the credit department for credit approval. Rough approximations of the billing values of the orders are made in the credit

\*Based on AICPA question paper, American Institute of Certified Public Accountants.

b. As an alternative to using a random number generator, an auditor can use systematic sampling to select an unbiased sample. Using systematic sampling, select the first five sample items for populations (1) through (3) from part a., using the random starting points shown. Recall that the sample size is 75 in each case.

- (1) Invoice #39
- (2) Bill of lading #18259
- (3) Page 1, line #11

**15-28 (OBJECTIVES 15-3, 15-5, 15-7)** Lenter Supply Company is a medium-sized distributor of wholesale hardware supplies in the central Ohio area. It has been a client of yours for several years and has instituted excellent internal controls for sales at your recommendation.

In providing control over shipments, the client has prenumbered "warehouse removal slips" that are used for every sale. It is company policy never to remove goods from the warehouse without an authorized warehouse removal slip. After shipment, two copies of the warehouse removal slip are sent to billing for the computerized preparation of a sales invoice. One copy is stapled to the duplicate copy of a prenumbered sales invoice, and the other copy is filed numerically. In some cases, more than one warehouse removal slip is used for billing one sales invoice. The smallest warehouse removal slip number for the year is 11741 and the largest is 34687. The smallest sales invoice number is 45302 and the largest is 65747.

In the audit of sales, one of the major concerns is the effectiveness of the controls in ensuring that all shipments are billed. You have decided to use audit sampling in testing internal controls.

- a. State an effective audit procedure for testing whether shipments have been billed. What is the sampling unit for the audit procedure?
- b. Assume that you expect no exceptions in the sample but are willing to accept a TER of 4%. At a 5% ARO, what is the appropriate sample size for the audit test? You may complete this requirement using attributes sampling.
- c. Design a random selection plan for selecting the sample from the population, using either systematic sampling or computer generation of random numbers. Use the sample size determined in part b. If you use systematic sampling, use a random starting point of 11878.
- d. Your supervisor suggests the possibility of performing other sales tests with the same sample as a means of efficiently using your audit time. List two other audit procedures that can conveniently be performed using the same sample, and state the purpose of each of the procedures.
- e. Is it desirable to test the occurrence of sales with the random sample you have designed in part c.? Why or why not?

**Required**

**15-29 (OBJECTIVE 15-7)** The following is a partial audit program for the audit of sales transactions.

1. Foot the sales journal for one month and trace the postings to the general ledger.
2. Review the sales journal for any large or unusual transactions.
3. Examine sales order for evidence of credit approval prior to shipment.
4. Vouch entries in sales journal to sales invoice and shipping document.
5. Examine evidence on sales invoice that the prices were agreed to the approved price list.
6. Recompute extensions of price and quantities on the sales invoice.
7. Trace entries in sales journal to entry in accounts receivable master file.

- a. Identify which audit procedures can be tested by using attributes sampling.
- b. What is the appropriate sampling unit for the tests in part a.?
- c. List the attributes for testing in part a.
- d. Assume an ARO of 5% and a TER of 6% for tests of controls and 5% for substantive tests of transactions. The EPER for tests of controls is 1.0%, and for substantive tests of transactions it is 0.5%. What is the initial sample size for each attribute?

**Required**

**15-32 (OBJECTIVE 15-7)** The following are auditor judgments and attributes sampling results for six populations. Assume large population sizes.

	1	2	3	4	5	6
EPER (in percent)	2	1	1	0	3	8
TER (in percent)	6	5	20	3	8	15
ARO (in percent)	5	5	10	5	10	10
Actual sample size	100	100	20	100	60	60
Actual number of exceptions in the sample	2	4	1	0	1	8

- For each population, did the auditor select a smaller sample size than is indicated by using the attributes sampling tables in Table 15-8 (p. 508) for determining sample size? What are the implications of selecting either a larger or smaller sample size than those determined using the tables?
- Calculate the SER and CUER for each population.
- For which of the six populations should the sample results be considered unacceptable? What options are available to the auditor?
- Why is analysis of the exceptions necessary even when the populations are considered acceptable?
- For the following terms, identify which is an audit decision, a nonstatistical estimate made by the auditor, a sample result, and a statistical conclusion about the population:
  - EPER
  - TER
  - ARO
  - Actual sample size
  - Actual number of exceptions in the sample
  - SER
  - CUER

**Required**

**15-33 (OBJECTIVES 15-5, 15-7)** Annie Zhao is using attributes sampling in testing controls over sales transactions. She is testing five attributes related to sales invoices using an ARO of 5% (confidence level of 95%), and zero expected deviations for each attribute based on prior experience with the client. Annie has determined that the tolerable exception rate for each attribute is 5%. Using her firm's audit software, she entered the population size (number of invoices), desired confidence level, TER, and EPER, and determined a sample size of 60 invoices. She used the audit software to select a random sample of invoices and performed the control tests. She found zero deviations for four of the five attributes and concluded that the control can be relied upon for each of those attributes. For the remaining attribute, she found one control deviation. In projecting the sample results to the population for the attribute with one control deviation identified, Annie entered the confidence level, sample size, and one deviation into the audit software sampling module and determined that the computed upper exception rate for the attribute is 7.92%.

- Explain how Annie should interpret the CUER of 7.92%.
- What should Annie conclude about the effectiveness of the control attribute with one identified deviation?
- What are the alternatives for Annie if she concludes the control cannot be relied upon?
- Assume Annie discusses the deviation with the controller and learns this deviation occurred while a temporary employee was covering for the regular clerk, who was on vacation. Would this information be relevant in determining which of the alternatives in answer c. would be the most appropriate response? What testing and documentation would be needed to conclude this control can be relied upon?

**Required**

**15-34 (OBJECTIVE 15-5)** For the audit of the financial statements of Mercury Fifo Company, Stella Mason, CPA, has decided to apply nonstatistical audit sampling in

