revenue recognition attracted the attention of the business media. The SEC has also expressed concerns about the number of instances of improper revenue recognition identified by SEC staff. One revenue issue involves "bill and hold" sales. Read the SEC guidance on revenue recognition (www.sec.gov/interps/account/sabcodet13.htm) to answer the following questions:

Required

a. What does the SEC indicate are the four basic criteria for determining whether revenue is realized or realizable?
b. What is a "bill and hold" transaction?
c. Why would a bill and hold transaction normally not qualify as a sale? What might justify recording a bill and hold transaction as a sale with a related receivable?
d. A customer of your audit client, Henson, LLC, made a formal, written request to establish a bill and hold arrangement in November 2016, an arrangement that is typical in the industry. The customer's written request outlines a delivery schedule that will begin in February 2017. As of November 2016, the product to be shipped in February is already complete and ready for shipment. Because the sale was completed in 2016, your audit client would like to record the bill and hold transaction described as a sale in 2016. You do not recall noticing any inventory held in a separate area of the client's warehouse during the December 31, 2016, inventory observation. In making your determination regarding the timing of the revenue recognition, what criteria has the SEC determined to be important?

16-24 (OBJECTIVES 16-1, 16-2, 16-4) You are responsible for designing the audit of notes receivable for Hickory Appliance Retailers, which sells appliances and electronics to consumers for their homes or small businesses. Hickory Appliance has eight store locations in different cities located in the upper Midwestern part of the United States. One of Hickory's unique competitive advantages has been its ability to offer more attractive credit terms for appliance purchases for their customers relative to traditional credit cards. Thus, most of their sales involve Hickory-financed purchases by their customers. As part of obtaining an understanding of the client's business and industry, you learned that some of the stores are located in cities that have recently experienced higher rates of unemployment.

Required

a. Which notes receivable balance-related audit objective(s) might have a high risk of material misstatement?
b. What risks, if any, would you consider to be a significant risk related to notes receivable?
c. How might the number of days receivables outstanding in the current year compare to prior years'?
d. Do you plan to send notes receivable confirmations in the current year? Why or why not?
e. To what extent will confirmations of notes receivable help you assess collectibility of the accounts as of year-end?

16-25 (OBJECTIVE 16-3) The following are common tests of details of balances or substantive analytical procedures for the audit of accounts receivable:

1. Select 10 customer accounts from the accounts receivable master file and trace to the aged accounts receivable listing to verify name and amount.
2. Select 10 customer accounts from the aged accounts receivable listing and trace to the accounts receivable master file for name, amount, and aging categories.
3. Obtain a list of aged accounts receivable, foot and cross-foot the list, and trace the total to the general ledger.
4. Compute accounts receivable turnover for the current year and compare to the prior year.
5. Perform alternative procedures on accounts not responding to second requests by examining subsequent cash receipts documentation and shipping reports or sales invoices.
6. Request 30 positive and 50 negative confirmations of accounts receivable.

Required

a. For each audit procedure, identify the balance-related audit objective or objectives it partially or fully satisfies.
b. In which order would the auditor perform the six procedures? Briefly justify your answer.

16-26 (OBJECTIVE 16-3) The following misstatements are sometimes found in the sales and collection cycle's account balances:

1. Several cash receipts were posted to the incorrect customer accounts.
2. A shipment made in the subsequent period is recorded as a current period sale.
3. The allowance for uncollectible accounts is inadequate because of the client's failure to reflect depressed economic conditions in the allowance.
4. Several accounts receivable are in dispute as a result of claims of defective merchandise.
5. The pledging of accounts receivable to the bank for a loan is not disclosed in the financial statements.
6. Goods were returned for credit on the last day of the fiscal year but the sales return was not recorded until the following fiscal year.
7. Several accounts receivable in the accounts receivable master file are not included in the aged trial balance.
8. One account receivable in the accounts receivable master file is included on the aged trial balance twice.
9. Long-term interest-bearing notes receivable from affiliated companies are included in accounts receivable.

Required

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.

16-27 (OBJECTIVE 16-3) The following are the eight balance-related audit objectives, six tests of details of balances for accounts receivable, and seven tests of controls or substantive tests of transactions for the sales and collection cycle:

Balance-Related Audit Objective

Detail tie-in	Classification
Existence	Cutoff
Completeness	Realizable value
Accuracy	Rights

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

1. Confirm accounts receivable ending balances and sales terms, such as right of return and consignment arrangements.
2. Review sales returns after the balance sheet date to determine whether any are applicable to the current year.
3. Compare dates on shipping documents with the sales journal throughout the year.
4. Perform alternative procedures for nonresponses to confirmations.
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 with the accounts receivable master file.
12. Trace from the sales journal to the accounts receivable master file to make sure the information is the same.

7. This confirmation was returned as undeliverable by the post office.
8. We are contesting the propriety of this $12,525 charge. We think the charge is excessive.
9. We do not owe this balance as our agreement with the company allows us to return any unsold goods without penalty. Amount okay. As the goods have been shipped to us on consignment, we will remit payment upon selling the goods.
10. Your credit memo dated December 5, 2015, in the amount of $440 cancels the balance above.

Required

a. Indicate which of these confirmation responses likely represent timing differences.
b. Which of the 10 confirmation responses likely represent a misstatement? Explain why the response indicates a misstatement.
c. For each of the 10 confirmation responses, indicate the procedures you would perform to determine whether the exception is a misstatement or has been appropriately recorded by the client.*

16-34 (OBJECTIVES 16-3, 16-5) The following are various changes in audit circumstances.

Audit Circumstance

1. Substantive analytical procedures indicated a significant slowing in accounts receivable turnover.
2. The client entered into sales contracts with new customers that differ from the client's standard sales contracts.
3. The client had a significant increase in sales near year-end.
4. Accounts receivable confirmations were ineffective due to a very low response rate in the prior year audit.
5. The client began experiencing an increase in returns due to product changes that resulted in increased defects.
6. You found several pricing errors in your substantive tests of transactions for sales.
7. In performing substantive tests of transactions for cash receipts, you found that receipts were promptly recorded in customer accounts, but there were delays in depositing the receipts at the bank.
8. The client entered into a new loan agreement with the bank. Accounts receivable are pledged as collateral for the loan.
9. The client did not reconcile the accounts receivable subsidiary records with the accounts receivable balance in the general ledger on a regular basis.

Required

Match each change in audit circumstance with the most likely test of details of balances response. Each response is used once.

a. Expand testing of sales returns after year-end and compare the level of returns with the prior year.
b. Send positive confirmations that include requests for information on side agreements and special terms.
c. Increase the number of accounts traced from the accounts receivable trial balance to the accounts receivable subsidiary records.
d. Expand the review of cash receipts after year-end to evaluate the collectibility of accounts receivable.
e. Increase the sample size for sales cutoff testing for sales recorded before year-end.
f. Send a confirmation to the bank confirming amounts pledged as collateral under loan agreements.
g. Increase the sample size for positive confirmations of accounts receivable.
h. While at the client's premises at year-end, obtain information on the last few cash receipts at year-end for cash receipts cutoff testing.
i. Perform alternative procedures to test the existence and accuracy of accounts receivable instead of sending positive confirmations.

16-35 (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

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

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:

Required

1. Confirmation request no. 9
   Customer name — Jolene Milling Co.
   Balance — $3,621 at December 31, 2016
   Subsequent cash receipts per the accounts receivable master file: January 15, 2017 — $1,837; January 29, 2017 — $1,263; February 6, 2017 — $1,429
2. Confirmation request no. 26
   Customer name — Rosenthal Repair Service
   Balance — $2,500 at December 31, 2016
   Subsequent cash receipts per the accounts receivable master file: February 9, 2017 — $500
   Sales invoices per the accounts receivable master file (I examined the duplicate invoice): September 1, 2016 — $4,200

Required

a. If you are asked to evaluate the adequacy of the sample size, the type of confirmation 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.

CASE

16-36 **(OBJECTIVES 16-1, 16-3, 16-4, 16-5)** You are auditing the sales and collection cycle for the Smalltown Regional Hospital, a small not-for-profit hospital. The hospital has a reputation for excellent medical services and deficient record keeping. The medical people have a tradition of doing all aspects of their job correctly, but because of a shortage of accounting personnel, there is not time for internal verification or careful performance. In previous years, your CPA firm has found quite a few misstatements in billings, cash receipts, and accounts receivable. As in all hospitals, the two largest assets are accounts receivable and property, plant, and equipment.

The hospital 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 the modern hospital that is being built in a nearby city. In the past, county taxes have made up deficits, but in the past year, the county has also been incurring deficits because of high unemployment.

In previous years, your response from patients to confirmation requests has been frustrating at best. The response rate has been extremely low, and those who did respond did not know the purpose of the confirmations or their correct outstanding balance. You have had the same experience in confirming receivables at other hospitals.

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. What risks would you consider to be significant risks?
d. For each of the following, explain whether you plan to emphasize the tests in the audit of the sales and collection cycle and give reasons:
   (1) Tests of controls
   (2) Substantive tests of transactions
   (3) Substantive analytical procedures
   (4) Tests of details of balances

3,000 accounts receivable with a gross value of $6,900,000. The accounts are similar in size and will be treated as a single stratum. Tolerable misstatement for this test of accounts receivable confirmations is $150,000.

Required

a. Calculate the required sample size. Assume your firm uses the following nonstatistical formula to determine sample size:

$$\text{Sample size} = \frac{\text{Population Recorded Amount} \times \text{Confidence Factor}}{\text{Tolerable Misstatement}}$$

A confidence factor of 2 is used for a 10% ARIA.

b. Assume that instead of good results, poor results were obtained for tests of controls and substantive tests of transactions for sales, sales returns and allowances, and cash receipts. How will this affect your required sample size? How will you use this information in your sample size determination?

c. Regardless of your answer to part a., assume you decide to select a sample of 100 accounts for testing. Indicate how you will select the accounts for testing using systematic selection.

d. Assume a total book value of $230,000 for the 100 accounts selected for testing. You uncover three overstatements totaling $1,500 in the sample. Evaluate whether the population is fairly stated.

17-24 (OBJECTIVE 17-2) You are evaluating the results of a nonstatistical sample of 85 accounts receivable confirmations for the Bohrer Company. Information on the sample and population are included below. Tolerable misstatement for accounts receivable confirmation sampling is $100,000.

		Sample		Population	
Stratum		**# of Accounts**	**Recorded Value**	**# of Accounts**	**Recorded Value**
1	> $75,000	8	$1,287,643	8	$1,287,643
2	$10,000–$74,999	40	1,349,678	257	4,348,268
3	< $10,000	25	94,637	712	947,682
		73	$2,731,958	977	$6,583,593

The confirmation responses were received without exception, other than the following items:

Acct. No.	Recorded Value	Confirmation Response	Auditor Follow-up
147	$ 24,692	$ 22,486	Customer was charged the wrong price.
228	183,219	157,216	$26,003 shipment recorded on December 30th; goods were not shipped until January 3rd.
278	7,546	5,546	Customer sent $2,000 payment on December 29th; received on January 2nd.
497	15,319	0	$17,443 shipment made on December 30th; goods were received by the customer on January 2nd.
564	8,397	7,858	Customer received less than the full quantity ordered.
653	32,687	19,328	$13,359 shipment recorded on December 30th; goods were not shipped until January 2nd.
830	5,286	0	$5,286 shipment recorded on December 30th; goods were not shipped until January 3rd.

a. Evaluate each of the confirmation exceptions to determine whether they represent misstatements. **Required**
b. Estimate the total amount of misstatement in the accounts receivable population. Ignore sampling risk in the calculation.
c. Is the population acceptable? If not, indicate what follow-up action(s) you consider appropriate in the circumstances.

17-25 (OBJECTIVES 17-2, 17-3) Assume you performed sampling for an accounts receivable population with a recorded population amount of $2,000,000. Tolerable misstatement is set at $100,000 for the test, and there are no individually significant accounts greater than $100,000. Several different sampling results for this population are presented below; the upper bound is the projected misstatement plus an allowance for sampling risk. The results presented are for an MUS sample, but the decision as to how to resolve the projected misstatement, including consideration of sampling risk, also applies to nonstatistical sampling. The differences in sample size reflect differences in confidence levels and expected misstatement used in designing the sample.

You are to make a recommendation as to the appropriate action to take given the sample results. Assume that the client is willing to record an audit adjustment for actual misstatements detected in your testing, but is unwilling to record an adjustment for projected errors. Issuing a qualified or adverse opinion is not included as an option. Because the audited financial statements are required under the terms of a loan agreement, the client will agree to additional testing or will correct the population if needed to receive an unmodified opinion.

	Sample Size	Interval	Number of Misstatements	Dollar Amount of Actual Misstatements	Projected Misstatement	Upper Bound	Nature of Misstatements
1.	54	36,450	1	20,000	20,000	104,200	Improper contract price applied
2.	46	43,290	3	425	4,731	106,979	Various pricing and quantity errors
3.	54	36,450	8	20,400	110,568	241,468	Incorrect shipments, cutoff errors, and pricing errors
4.	33	60,385	1	4,000	12,077	114,007	Incorrect currency translation on foreign shipment
5.	72	27,500	1	400	7,333	95,333	Incorrect product shipped
6.	44	44,845	2	2,500	29,897	112,934	Duplicate shipment, incorrect price

For each of the sampling results 1 through 6, recommend the appropriate response(s) from the options listed below. Explain the reason for your decision. **Required**
a. Accept the population as fairly stated.
b. Request the client to record an adjustment for the actual misstatements.
c. Expand the sample size.
d. Request the client to fix the population, which will then be reaudited.
e. Treat the misstatement as an anomaly that is an isolated occurrence that should not be projected to the population.

17-26 (OBJECTIVE 17-3) The accounts receivable population for Jake's Bookbinding Company follows. This table is the same as Table 17-1 on page 567, except that cumulative amounts are included to assist you in completing the problem. The population is smaller than is ordinarily the case for statistical sampling, but an entire population is useful to show how to select PPS samples.

a. Select a random PPS sample of 10 items, using computer software. **Required**
b. Select a sample of 10 items using systematic PPS sampling. Use a starting point of 1857. Identify the physical units associated with the sample dollars.

c. Which sample items will always be included in the systematic PPS sample regardless of the starting point? Will that also be true of random PPS sampling?
d. Which method is preferable in terms of ease of selection in this case?
e. Why will an auditor use MUS?

Population Item	Recorded Amount	Cumulative Amount	Population Item (cont.)	Recorded Amount (cont.)	Cumulative Amount (cont.)
1	$ 1,410	$ 1,410	21	$ 4,865	$117,385
2	9,130	10,540	22	770	118,155
3	660	11,200	23	2,305	120,460
4	3,355	14,555	24	2,665	123,125
5	5,725	20,280	25	1,000	124,125
6	8,210	28,490	26	6,225	130,350
7	580	29,070	27	3,675	134,025
8	44,110	73,180	28	6,250	140,275
9	825	74,005	29	1,890	142,165
10	1,155	75,160	30	27,705	169,870
11	2,270	77,430	31	935	170,805
12	50	77,480	32	5,595	176,400
13	5,785	83,265	33	930	177,330
14	940	84,205	34	4,045	181,375
15	1,820	86,025	35	9,480	190,855
16	3,380	89,405	36	360	191,215
17	530	89,935	37	1,145	192,360
18	955	90,890	38	6,400	198,760
19	4,490	95,380	39	100	198,860
20	17,140	112,520	40	8,435	207,295

17-27 **(OBJECTIVE 17-3)** In the audit of Price Seed Company for the year ended September 30, the auditor set a tolerable misstatement of $50,000 at an ARIA of 10%. A PPS sample of 100 was selected from an accounts receivable population that had a recorded balance of $1,975,000. The following table shows the differences uncovered in the confirmation process:

Accounts Receivable per Records	Accounts Receivable per Confirmation	Follow-up Comments by Auditor
1. $2,728.00	$2,498.00	Pricing error on two invoices.
2. $5,125.00	-0-	Customer mailed check 9/26; company received check 10/3.
3. $3,890.00	$1,190.00	Merchandise returned 9/30 and counted in inventory; credit was issued 10/6.
4. $ 815.00	$ 785.00	Footing error on an invoice.
5. $ 548.00	-0-	Goods were shipped 9/28; customer received goods on 10/2; sale was recorded on 9/28.
6. $3,215.00	$3,190.00	Pricing error on a credit memorandum.
7. $1,540.00	-0-	Goods were shipped on 9/29; customer received goods 10/3; sale was recorded on 9/30.

Required

a. Calculate the upper misstatement bound on the basis of the client misstatements in the sample.
b. Is the population acceptable as stated? If not, what options are available to the auditor at this point? Which option should the auditor select? Explain.