

Illustrative Audit Case: Keystone Computers & Networks, Inc.

Part III: Substantive Tests—Accounts Receivable and Revenue

This part of the audit case illustrates the manner in which the auditors design substantive tests of balances. The substantive tests are illustrated for two accounts—receivables and revenue. This aspect of the audit is illustrated with the following audit documentation:

- ABC's risk assessment working paper that combines the auditors' assessments of inherent and control risks into an overall risk of material misstatement for the assertions.
- The substantive audit program of accounts receivable and revenue.
- The audit sampling plan for the confirmation of accounts receivable.

Adams, Barnes & Co.'s assessment of control risk is described in Part II of the audit case on pages 479–492. To refresh your knowledge of the case, review that part as well as Part I on pages 235–242 of Chapter 6.

KEYSTONE COMPUTERS & NETWORKS, INC.
Relating Risks to Further Audit Procedures
12/31/XX

RA-12
808
11/28/25

Ref	Description of Risk	Significant Risk?	Relevant Assertion(s)	Assessed Risks of Material Misstatement			Summary of Audit Approach	Ref
Item No.				Inherent	Control	Combined Risk of Material Misstatement		Audit Program Step
Revenue—Overall Risks								
	Gross Receivables and Gross Revenue	No	Existence/ Occurrence/ Rights	High	Moderate	Moderate	<ul style="list-style-type: none"> • Confirm receivables by PPS sample at 12/31/XX. • Use generalized audit software to test client records. • Perform extensive cutoff of sales. • Perform substantive analytical procedures. 	B-6, Steps 1–7
		No	Completeness	Moderate	Low	Moderate/Low		B-6, Step 3
		No	Cutoff	Moderate	Moderate	Moderate		B-6, Step 12
		No	Accuracy	Moderate	Moderate	Moderate		B-6, Step 14
Revenue—Specifically Identified Risks								
1	Inherent Risk Considerations Audited financial statements are required by Western Financial Services as a part of the company's line of credit agreement.	No	Existence/ Occurrence	Moderate	Moderate	Moderate	During the brainstorming session, staff members were informed of the need to increase their professional skepticism regarding any matters that would increase the amount of net income.	
2	Inherent Risk Considerations KCN has engaged in a strategy to sell to customers with higher credit risk.	Yes	Valuation	High	Moderate	High	In Process	
3	Inherent Risk Considerations The officers of the company receive significant bonuses based on quarterly results.	Yes	Existence/ Occurrence	High	Moderate	Moderate/High	In Process	

Audit Program—Substantive Tests—Accounts Receivable and Revenues

B-6
WLP
 11/13/25

Client: *Kapitana Computers & Networks, Inc.*

Financial Statement Date: *12/31/25*

Procedure	Performed by	
	Initials	Date
Sales Transactions		
1. Obtain an aged trial balance of accounts receivable as of 12/31/25.	<u>MP</u>	<u>11/6/26</u>
2. Select a sample of customers' accounts at 12/31/25 for positive confirmation using probability-proportional-to-size sampling based on the following parameters:		
a. Risk of incorrect acceptance of 5%.		
b. Tolerable misstatement of \$150,000.		
c. Expected misstatement of \$20,000.	<u>MP</u>	<u>11/7/26</u>
3. Use generalized audit software to:		
a. Foot the master file of accounts receivable at 12/31/25.	<u>MP</u>	<u>2/12/26</u>
b. Test the client-prepared aging of accounts receivable.	<u>MP</u>	<u>11/7/26</u>
c. Select the specific accounts for confirmation.	<u>MP</u>	<u>11/7/26</u>
4. Mail accounts receivable confirmation requests.	<u>MP</u>	<u>11/6/26</u>
5. Send second requests for all unanswered confirmation requests.	<u>MP</u>	<u>1/25/26</u>
6. For confirmation requests to which no reply is received, perform the following alternative procedures:		
a. Test items subsequently paid to remittance advices which identify the specific invoices paid. If necessary, reconcile the amounts paid to sales invoices and delivery receipts.	<u>MP</u>	<u>2/16/26</u>
b. For items not paid, inspect the invoices and delivery receipts for the sales transactions making up the account balance.	<u>MP</u>	<u>2/16/26</u>
7. Resolve exceptions noted on confirmation requests.	<u>MP</u>	<u>2/16/26</u>
8. Review credit files for customers with accounts receivable above \$150,000 at 12/31/25. Investigate any indications of fictitious accounts.	<u>MP</u>	<u>2/16/26</u>
9. Summarize the results of the confirmation procedures.	<u>MP</u>	<u>2/16/26</u>

(continued)

Audit Program—Substantive Tests—Accounts Receivable and Revenues

B-6
WLP
 11/13/15

(Concluded)

Client: *Keystone Computers & Networks, Inc.*

Financial Statement Date: *12/31/15*

Procedure	Performed by	
	Initials	Date
10. Review the adequacy of the allowance for uncollectible accounts by performing the following procedures:		
a. Review the aged trial balance of accounts receivable with the president.	<i>WLP</i>	<i>2/13/16</i>
b. Review confirmation exceptions for indications of disputed amounts.	<i>WLP</i>	<i>2/13/16</i>
c. Analyze and review trends in the following relationships:		
(1) Accounts receivable to net sales.	<i>WLP</i>	<i>2/15/16</i>
(2) Allowance for bad debts to accounts receivable.	<i>WLP</i>	<i>2/15/16</i>
(3) Bad debt expense to net sales.	<i>WLP</i>	<i>2/15/16</i>
11. At year-end, review the file of sales invoices that are waiting to be matched with delivery receipts for any sales transactions that were not executed and, therefore, should be recorded in the subsequent period.	<i>MP</i>	<i>12/31/15</i>
12. For all sales recorded in the last week of the year, inspect the related delivery receipt to determine that the sale occurred before 12/31/15.	<i>MP</i>	<i>2/12/16</i>
13. Review credit memoranda for sales returns and allowances through the last day of fieldwork to determine if an adjustment is needed to record the items as of year-end.	<i>MP</i>	<i>2/16/16</i>
14. Perform analytical procedures for sales and accounts receivable including comparison of the following to prior years and/or industry data:	<i>WLP</i>	<i>2/12/16</i>
a. Gross profit percentage by month.	<i>WLP</i>	<i>2/12/16</i>
b. Sales by month by salesperson.	<i>WLP</i>	<i>2/16/16</i>
c. Accounts receivable turnover.	<i>WLP</i>	<i>2/16/16</i>
d. Advertising expense as a percentage of sales.	<i>WLP</i>	<i>2/16/16</i>
e. Net receivables as a percentage of total current assets.	<i>WLP</i>	<i>2/16/16</i>
15. Ascertain whether any accounts have been assigned, pledged, or discounted by review of agreements and confirmation with banks.	<i>WLP</i>	<i>2/13/16</i>
16. Ascertain by inquiry whether any accounts are owed by employees or related parties such as officers, directors, or shareholders, and:		
a. Obtain an understanding of the business purpose for the transactions that resulted in the balances.	<i>WLP</i>	<i>2/16/16</i>
b. Ascertain the amounts involved.	<i>WLP</i>	<i>2/16/16</i>
c. Confirm the balances.	<i>WLP</i>	<i>1/25/16</i>

KEYSTONE COMPUTERS & NETWORKS, INC.
Audit Sample Plan for Confirmation of Accounts Receivable
12/31/X5

B-9
802
11/12/16

Objective: *Establish the existence and gross valuation of accounts receivable and occurrence and accuracy of sales by confirmation.*

Population: *The trial balance of 933 accounts receivable at 12/31/X5, with a total book value of \$10,235,457.*

Definition of Misstatement: *Any amount that is determined not to be a valid account receivable.*

Sampling Technique: *Probability-proportional-to-size.*

Sampling Parameters:

1. Tolerable misstatement:

Total materiality as indicated in the audit plan

\$300,000

Less: Estimate of undetected misstatement (50% of overall materiality)

150,000

Tolerable misstatement for this test

\$150,000

2. Risk of incorrect acceptance:

Because we have assessed the risk of material misstatement as high, the risk of incorrect acceptance will be set at 5 percent.

3. Expected misstatement:

Based on prior-year audits, the expected misstatement for the account is \$20,000.

Calculation of Sample Size and Sampling Interval:

$$\begin{aligned} \text{Sample size} &= \frac{\text{Book value of population} \times \text{Reliability factor}}{\text{Tolerable misstatement} - (\text{Expected misstatement} \times \text{Expansion factor})} \\ &= \frac{\$10,235,457 \times 3.00}{\$150,000 - (\$20,000 \times 1.6)} \\ &= 260 \\ \text{Sampling interval} &= \frac{\text{Book value of population}}{\text{Sample size}} = \frac{\$10,235,457}{260} = \$39,400 \text{ (rounded)} \end{aligned}$$

Actual sample size was only 192 because a number of accounts were more than twice the sampling interval.

KEYSTONE COMPUTERS & NETWORKS, INC.
Monthly Sales Report
For the Three Years Ended 12/31/X5

B-11
802
11/9/16

	Sales of Computers			Consulting Revenue			Service Revenue		
	20X3	20X4	20X5	20X3	20X4	20X5	20X3	20X4	20X5
January	3,348,340	3,479,482	3,268,584	3,626,893	3,521,682	3,180,808	342,440	341,981	307,519
February	3,365,453	3,692,918	3,593,775	4,145,019	3,519,281	3,328,754	369,309	390,835	348,522
March	3,667,774	3,782,262	3,781,385	3,857,171	3,849,059	3,772,588	369,310	366,410	378,522
April	3,741,928	3,638,318	3,176,864	3,799,601	3,802,120	3,402,726	372,440	390,835	359,525
May	3,810,378	3,628,391	3,360,305	3,914,740	3,708,240	3,513,685	376,180	366,408	348,522
June	3,747,632	3,797,153	3,727,187	3,799,601	3,942,939	4,105,463	399,610	415,263	389,174
July	3,884,532	3,484,446	3,318,613	4,202,589	3,708,240	3,550,671	396,180	390,835	348,874
August	3,873,124	3,742,554	3,568,760	3,972,310	4,083,758	3,772,588	368,810	366,408	348,522
September	3,850,307	3,980,806	3,885,613	3,914,740	3,942,939	4,290,394	389,510	390,535	409,525
October	3,998,615	3,792,190	3,160,187	4,317,728	4,083,758	3,883,546	421,750	391,335	369,274
November	4,186,852	3,841,826	3,539,576	4,202,589	4,271,517	4,179,435	385,780	390,635	348,874
December	4,203,965	4,030,442	3,964,826	4,145,019	4,318,457	4,697,241	376,580	366,408	368,924
Total	<u>45,678,900</u>	<u>44,890,788</u>	<u>42,345,675</u>	<u>47,898,000</u>	<u>46,751,990</u>	<u>45,677,899</u>	<u>4,567,899</u>	<u>4,567,888</u>	<u>4,325,777</u>

Note: Amounts are presented in X5 currency. See Keystone's annual books.