

ACC531: Auditing and Assurance Services  
Ch7. Revenue and Collection Cycle

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- 1 Revenue and Collection Cycle: Typical Activities
- 2 Significant Accounts and Relevant Assertions
- 3 Risk of Material Misstatement: Revenue Recognition
- 4 Internal Control Activities and Design Evaluation
- 5 Tests of Operating Effectiveness of Internal Control
- 6 Substantive Analytical Procedures and Tests of Details

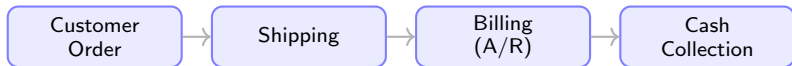
### LO 7-1

Describe the revenue and collection cycle, including typical source documents.

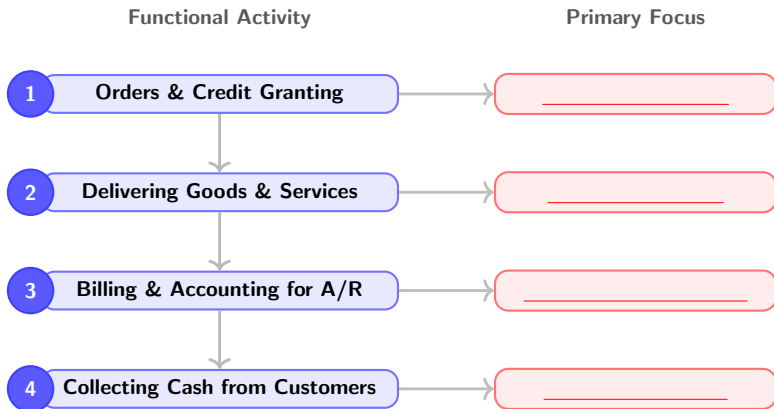
# The Revenue and Collection Cycle

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- The revenue and collection cycle encompasses all activities from customer order to cash collection.
- Auditors begin by understanding the cycle: activities, source documents, and how transactions flow through accounting systems.



# Four Functional Activities



## Step 1: Orders & Credit Granting

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**Phase Goal:** Approving customers and initiating the transaction correctly.

### Key Source Documents & Files

- **Customer Purchase Order (PO):** The \_\_\_\_\_ request from the customer.
- **Price Master File:** The system file of authorized prices.
- **Credit Application / Credit File:** Limits and approval history.
- **Sales Order:** The \_\_\_\_\_ document generated to process the requested items.

### What Could Go Wrong?

- \_\_\_\_\_: Granting credit to non-creditworthy customers.
- \_\_\_\_\_ Sales: Recording orders that were never actually placed.

A **Customer Purchase Order (PO)** is a commercial document issued by a \_\_\_\_\_ to a seller. It indicates types, quantities, and agreed prices for products or services.

### PURCHASE ORDER

From: ABC Retailers

PO #: 90210

To: XYZ Wholesale

Date: Oct 1, 2026

Item	Description	Qty	Expected Price
A12	Office Chairs	50	\$100.00
B45	Standing Desks	20	\$250.00

A **Price Master File** is an internal master computer file containing authorized baseline prices for products. This limits employee ability to bill at \_\_\_\_\_ amounts.

### PRICE MASTER FILE (IT System)

Last Updated: Sep 28, 2026

Item Code	Description	Authorized Sales Price
A12	Office Chairs	\$100.00
A13	Premium Chairs	\$150.00
B45	Standing Desks	\$250.00

A **Credit Application** is submitted by the customer; the company's **Credit File** stores the \_\_\_\_\_ and payment history. The credit department — separate from sales — uses this file to authorize or block each order.

### CREDIT FILE — ABC Retailers

Customer: ABC Retailers      Acct #: 404  
Credit Officer: J. Davis Last Review: Sep 15, 2026

Field	Value
Approved Credit Limit	\$50,000
Current Balance (A/R)	\$12,400
Available Credit	
Payment History	<u>Excellent</u>
<hr/>	
<i>New order total: \$10,000</i>	<i>Status: <b>APPROVED</b></i>

A **Sales Order** is an \_\_\_\_\_ document generated by the company. It translates the customer's PO into a standardized format and is sequentially \_\_\_\_\_<sup>1</sup>.

### SALES ORDER (Internal)

Customer: ABC Retailers SO #: 1055 (Prenumbered)  
Ref PO: 90210 Credit Approved:  Yes (Auth: JD)

Item	Description	Qty	Approved Price
A12	Office Chairs	50	\$100.00
B45	Standing Desks	20	\$250.00

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<sup>1</sup>Sequential prenumbering allows MGT to identify and investigate missing transaction numbers, testing the *completeness* assertion.

## Step 1: Synthesizing the Sales Order

The internal **Sales Order** is authorized and generated **only after** successfully reconciling the customer's request with the company's master controls.



- If prices on the PO do not match the Price Master File, a discrepancy is logged.
- If the projected total exceeds the approved Credit File limit, the order is blocked.

**Phase Goal:** Transfer of goods and satisfaction of performance obligation.

### Key Source Documents

- \_\_\_\_\_: Contract transferring custody to the carrier.
- \_\_\_\_\_: Detailed list included inside the package.
- **Shipping Document:** Internal record that shipping occurred.

### What Could Go Wrong?

- **Cutoff issues:** Goods shipped but recorded in the wrong period.
- **Theft:** \_\_\_\_\_ of inventory directly from the warehouse.

A **Bill of Lading** is a legally binding contract between the shipper (company) and the carrier (e.g., FedEx) transferring physical \_\_\_\_\_ of the goods.

### UNIFORM STRAIGHT BILL OF LADING

Shipper: XYZ Wholesale Carrier: FreightCo Date: Oct 4, 2026  
Consignee: ABC Retailers BOL #: 88392

Pkgs	Description of Articles	Weight (lbs)	Class
2	Pallets - Office Chairs	1,500	70
1	Pallet - Standing Desks	800	70

Carrier Signature: John Doe

A **Packing Slip** is a list included *inside* the shipment detailing the exact items shipped. It does not typically include prices, only quantities.

### PACKING SLIP

Included in Shipment #: 88392 Date: Oct 4, 2026

Item Code	Description	Qty Shipped
A12	Office Chairs	50
B45	Standing Desks	20

A **Shipping Document** is an \_\_\_\_\_ record prepared by the shipping department confirming that goods left the warehouse. It is sequentially \_\_\_\_\_ and links the physical shipment to the \_\_\_\_\_ and the \_\_\_\_\_.

### SHIPPING DOCUMENT (Internal)

Ship Doc #: SD-4471 (Prenumbered) Date: Oct 4, 2026  
Sales Order Ref: SO-1055 BOL Ref: 88392

Item	Description	Qty Shipped	Warehouse Out
A12	Office Chairs	50	Bin 3-A
B45	Standing Desks	20	Bin 7-C

Shipped by: T. Wong Verified by: M. Lee

**Phase Goal:** Recording the revenue and recognizing the receivable balance.

### Key Source Documents & Records

- \_\_\_\_\_: The official bill sent to the customer requesting payment.
- \_\_\_\_\_: Primary accounting record for logging credit sales.
- A/R Subsidiary Ledger: Detailed ledger tracking specific customer balances.

### What Could Go Wrong?

- \_\_\_\_\_: Recording fictitious sales to inflate revenue.
- \_\_\_\_\_: Billing for an incorrect quantity or using the wrong price.

The **Sales Invoice** is the official bill sent to the customer requesting payment. It combines the \_\_\_\_\_ from the shipping document with the \_\_\_\_\_ from the approved Sales Order.

### SALES INVOICE

Bill To: ABC Retailers

Invoice #: INV-9901

Terms: 2/10, Net 30

Date: Oct 5, 2026

Item	Description	Qty x Price	Line Total
A12	Office Chairs	50 x \$100.00	\$5,000.00
B45	Standing Desks	20 x \$250.00	\$5,000.00
<b>Total Due</b>			<b>\$10,000.00</b>

The **Sales Journal** is the specialized accounting record where all authorized credit sales are officially logged before being posted to the General Ledger. It supports the \_\_\_\_\_ and \_\_\_\_\_ assertions.

### SALES JOURNAL (October 2026)

Date	Customer Account	Invoice #	Sales Rev Cr. / A/R Dr.
Oct 4	LMN Corp	INV-9900	\$1,500.00
Oct 5	ABC Retailers	INV-9901	\$10,000.00
Oct 5	XYZ Wholesale	INV-9902	\$4,250.00

The **A/R Subsidiary Ledger** tracks every individual client's running balance separately, ensuring we know exactly \_\_\_\_\_. This supplements the general ledger.

### A/R SUBSIDIARY LEDGER – ABC Retailers (Acct #: 404)

Date	Reference	Debit (Increase)	Credit (Decrease)	Balance
Oct 1	Beg. Balance			\$0.00
Oct 5	INV-9901	\$10,000.00		\$10,000.00

## Step 4: Collecting Cash from Customers

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**Phase Goal:** Receiving cash from the customer and correctly clearing their A/R balance.

### Key Source Documents

- \_\_\_\_\_: Slip returned with the payment specifying the invoice.
- \_\_\_\_\_: Bank document listing cash and checks being deposited.
- \_\_\_\_\_: Listing of all daily cash/check intakes.

### What Could Go Wrong?

- \_\_\_\_\_: Cash stolen upon arrival or in transit.
- \_\_\_\_\_: Stealing a payment and hiding it via misapplying later payments.

A **Remittance Advice** is usually a tear-off slip that the \_\_\_\_\_ returns along with their check. It explicitly tells the accounting department *which* invoice to mark as paid.

### REMITTANCE ADVICE

Return this portion with your payment.

<b>Customer Acct #</b>	<b>Paying Invoice #</b>	<b>Amount Enclosed</b>
404 (ABC Retailers)	INV-9901	\$9,800.00

*Note: 2% discount taken for payment within 10 days.*

A **Deposit Slip** is provided by the \_\_\_\_\_ and filled out by the cashier. It totals the day's checks and serves as independent third-party \_\_\_\_\_ that cash was actually banked.

### BANK DEPOSIT TICKET

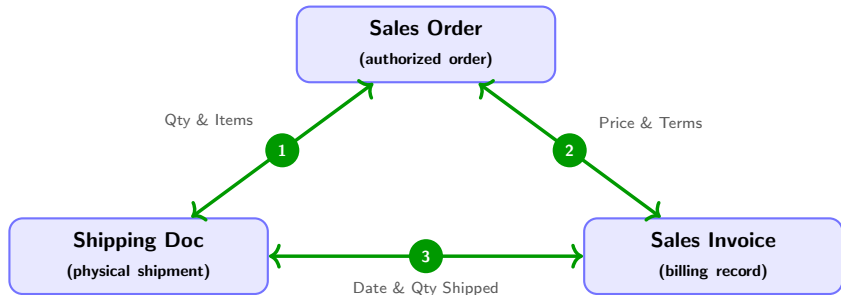
Account: XYZ Wholesale Operating

Date: Oct 8, 2026

Type	Check / Routing #	Amount
Check	#1199 (ABC Retailers)	\$9,800.00
Check	#5532 (Other Company)	\$3,200.00
<b>Total Deposit</b>		<b>\$13,000.00</b>

## Control: The 3-Way Match

Auditors look for a robust **Three-Way Match** to ensure the \_\_\_\_\_ (Revenue) and \_\_\_\_\_ (A/R) assertions. Mismatches block the sale from being recorded.



- **Match 1** (SO ↔ Shipping Doc): Ship only what the customer ordered.
- **Match 2** (SO ↔ Invoice): Bill at the price authorized on the sales order.
- **Match 3** (Shipping Doc ↔ Invoice): Bill only for what was physically shipped, on the correct date.

# Audit Test: Vouching for Occurrence

**Objective:** Did the recorded sale actually take place?

**Direction:** Vouch *backwards* from the accounting records to the source documents.

## SOURCE DOCUMENT

### Shipping Document

Date	BOL #	Qty Shipped
10/04	BOL-88391	55 units
10/05	BOL-88392	70 units
<b>MISSING</b>	—	—
10/07	BOL-88394	30 units

## ACCOUNTING RECORD

### Sales Journal

Date	Invoice #	Amount
10/04	INV-9900	\$8,200
10/05	INV-9901	\$10,000
<b>10/06</b>	<b>INV-9902</b>	<b>\$4,500</b>
10/07	INV-9903	\$6,300

**Vouching**

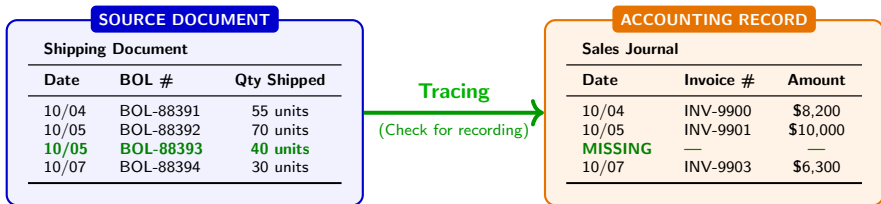
(Check for evidence)

Audit Finding INV-9902 appears in the Sales Journal, but no matching BOL exists in the Shipping Document. \_\_\_\_\_ fails — this may be a \_\_\_\_\_ sale.

# Audit Test: Tracing for Completeness

**Objective:** Was everything that shipped actually billed?

**Direction:** Trace *forwards* from the source documents to the accounting records.



Audit Finding BOL-88393 appears in the Shipping Document, but no matching invoice exists in the Sales Journal. \_\_\_\_\_ fails — goods were shipped but never billed.

Usually, the documents are generated by the electronic system (e.g., ERP).

- **Sales detail file** — lists all recorded sales transactions
- **Pending order / back-order file** — orders entered but not yet fulfilled
- **Customer master file** — credit limits, pricing, billing address
- **Price list file** — authorized prices for billing<sup>2</sup>
- **Sales analysis reports** — periodic comparisons by product, region, or salesperson
- **A/R aging schedule** — lists balances by age; primary tool for evaluating collectability

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<sup>2</sup>Exception reports flag invoices where the system could not match a price; auditors review these.

## Practice Questions

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- 1 Which document provides primary evidence that a sale has been physically completed by shipping goods to the customer?
- A) Sales order
  - B) Sales invoice
  - C) Bill of lading
  - D) Remittance advice
- 2 [T/F] Sequential prenumbering of source documents helps auditors test the completeness of recorded transactions.
- 3 [T/F] The employee who has custody of cash should also be responsible for recording cash receipts in the journal.

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### LO 7-2

Identify significant accounts and relevant assertions related to the revenue and collection cycle.

# What Makes an Account Significant?

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An account/disclosure is significant if there's a reasonable chance it could contain a \_\_\_\_.

Auditors identify significant accounts and relevant assertions by applying the **audit risk model** (introduced in Ch4):

- ① Set \_\_\_\_\_ at desired levels.
- ② Assess \_\_\_\_\_:
  - ▶ *Inherent risk* — nature of the account
  - ▶ *Control risk* — effectiveness of internal controls
  - ▶ (*Fraud Risk*) — improper revenue recognition
- ③ Set \_\_\_\_\_ at each significant account/assertion level.

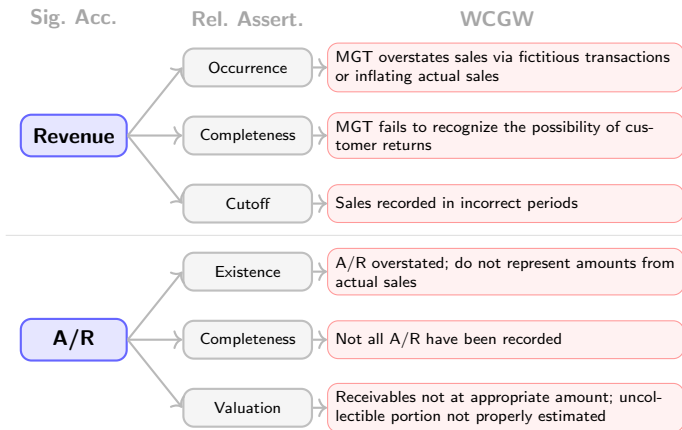
## Inherent Risk: Occurrence Over Completeness

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Auditors generally presume MGT has an incentive to \_\_\_\_\_ revenue and A/R.

	<b>Assertion</b>	<b>Risk Direction</b>	<b>Inherent Risk</b>
Revenue	Occurrence	Overstatement	<b>Higher</b>
Revenue	Completeness	Understatement	Lower
A/R	Existence	Overstatement	<b>Higher</b>
A/R	Completeness	Understatement	Lower

# What Could Go Wrong? (WCGW)



## Practice Questions

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- 1 Recording sales in December for goods that were not shipped until January is a failure of which assertion?<sup>3</sup>
- A) Occurrence
  - B) Completeness
  - C) Valuation
  - D) Cutoff
- 2 [T/F] The valuation assertion for accounts receivable relates to whether the balance is realizable — net of the allowance for uncollectible amounts.
- 3 [T/F] Fictitious sales recorded in the ledger represent a failure of the completeness assertion for revenue.
- 4 [T/F] Inherent risk for the occurrence assertion for revenue is typically higher than for the completeness assertion because MGT has an incentive to overstate revenue.

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<sup>3</sup>Choose the best one that describes the issue.

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### LO 7-3

Discuss the risk of material misstatement in the revenue and collection cycle, with a specific focus on improper revenue recognition.

Three primary WCGW risks:

- **Fictitious revenues** — recording sales that never occurred
- **Premature recognition** — recording before performance obligation is satisfied
- **Channel stuffing** — pushing excess inventory to distributors to inflate period sales

Fictitious  
Revenues

Premature  
Recognition

Channel  
Stuffing

## When Is Revenue Earned? SEC Criteria

The SEC holds that revenue is realizable and earned when **all four** criteria are met:

	<b>Criterion</b>	<b>Key Audit Question</b>
1	Persuasive evidence of an arrangement	Is there a signed contract, PO, or binding agreement?
2	Delivery has occurred (or services rendered)	Have goods shipped / title transferred / service completed?
3	Price is fixed or determinable	Is the amount free of contingencies that could alter it?
4	Collectability is reasonably assured	Is the customer creditworthy; is bad debt provision adequate?

Failure of **any one** criterion means revenue should **not** be recognized.

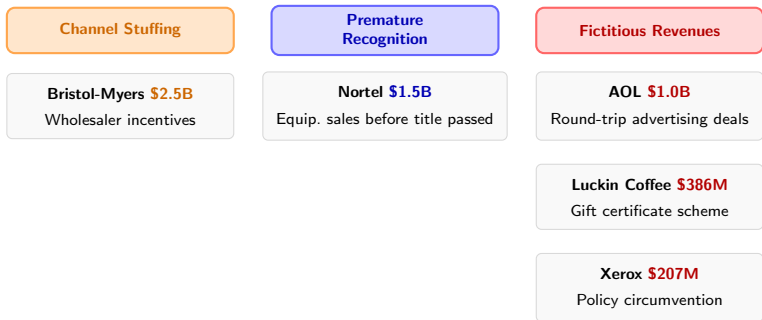
- ❶ If criterion 2 is not met, it is \_\_\_\_\_<sup>4</sup>
- ❷ If criterion 4 is not met, it is **channel stuffing**<sup>5</sup>

<sup>4</sup>a contract where a seller invoices a customer for goods but retains physical possession, often due to customer space constraints or production delays.

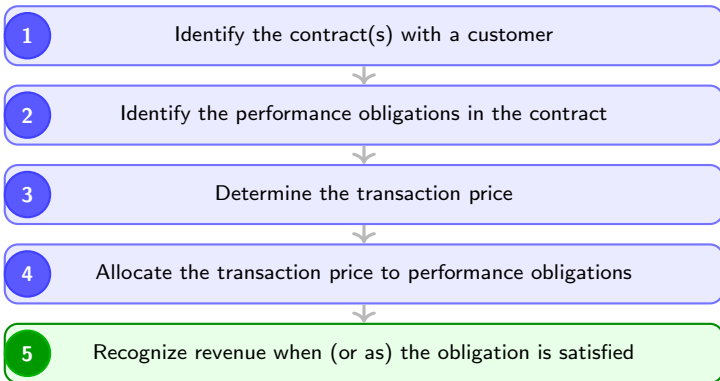
<sup>5</sup>a deceptive accounting practice where a company sends excessive inventory to distributors or customers just before the end of a financial period, booking these shipments as sales to artificially boost revenue.

# Revenue Recognition Rogues<sup>6</sup>

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<sup>6</sup>Selected cases; dollar amounts are restatement totals. Source: Louwers Exhibit 7.5.



Key challenge: contracts with \_\_\_\_\_ — each must be identified and allocated a portion of the transaction price.

- GAAP requires an allowance for doubtful accounts based on estimated uncollectible amounts
- Estimation is subjective — especially when clients change customers, products, or credit policies
- Economic downturns further complicate the estimate; \_\_\_\_\_ is therefore a high-risk assertion

- Customers generally have the right to return unused or unsold merchandise
- Companies must estimate \_\_\_\_\_ for returns, warranties, and contingent obligations at period end
- \_\_\_\_\_ — unknown return rights not disclosed to auditors — are a significant fraud risk
- New products / technologies have higher inherent risk because historical return rates may not exist

- 1 Under AU-C 240, auditors must treat revenue recognition as a fraud risk: \_\_
- A) Only when there is specific evidence of fraud
  - B) Only for issuers (public companies)
  - C) For every audit, unless the presumption is specifically rebutted
  - D) Only when the client has a history of revenue restatements
- 2 [T/F] Channel stuffing involves shipping excess products to distributors at period-end to inflate reported revenue. \_\_
- 3 [T/F] Under ASC 606, revenue is recognized when cash is received from the customer. \_\_

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## LO 7-4

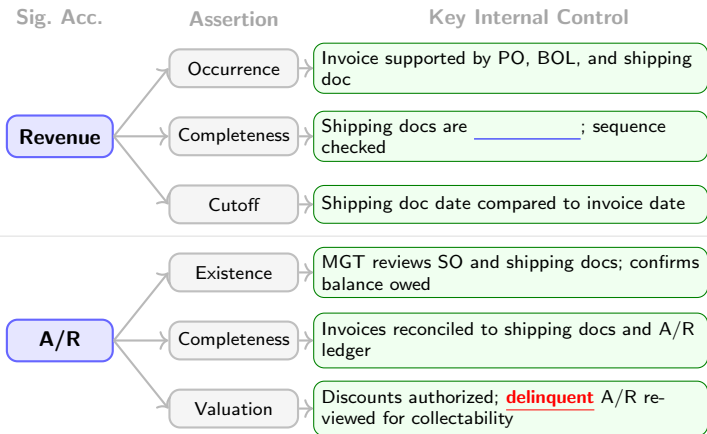
Identify significant internal control activities present in a properly designed system to mitigate the risk of material misstatements for each relevant assertion in the revenue and collection cycle.

## Entity-Level Controls

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- Entity-level controls are **pervasive** — they apply across the entire revenue cycle, not just individual transactions.
- **Control environment signals:** if MGT gives sales bonuses based on revenue targets, auditors recognize pressure to \_\_\_\_\_ revenue.
- MGT should have a process to continually review \_\_\_\_\_ (unusual or unexpected items).
- MGT should actively monitor \_\_\_\_: aging, uncollectible ratios, and timeliness of collections.

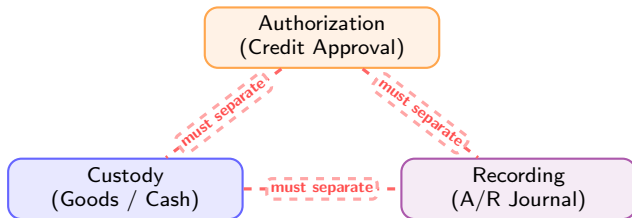
# Key Control Activities by Assertion



## Separation of Duties

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The most critical entity-level control in the revenue cycle is \_\_\_\_\_.

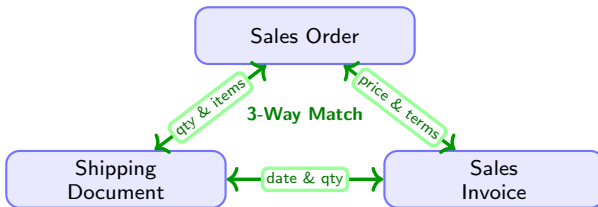


- **Combining** two or more functions opens the door for undetected errors or fraud.
- In small businesses: owner must take an **active role** — approve credit, review aged A/R, prepare bank reconciliations.

- A \_\_\_\_\_ traces one or a few transactions through the entire revenue cycle — from customer order to cash collection.
- Purpose: confirm controls are \_\_\_\_\_, not just documented.

# Three-Way Match

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Mismatches signal a control breakdown:

wrong price, unauthorized shipment, or recording error.

- 1 Which control best mitigates the risk of recording sales in incorrect periods (cutoff assertion)?
- A) Requiring customer purchase orders for all sales
  - B) Comparing the date on the shipping document to the date on the sales invoice
  - C) Sending positive confirmations to all customers at year-end
  - D) Requiring the controller to approve all sales journal entries
- 2 [T/F] A walkthrough is primarily used to test whether controls have been operating effectively throughout the entire year.
- 3 [T/F] In small businesses where separation of duties is impractical, the owner's active involvement can serve as a compensating control.

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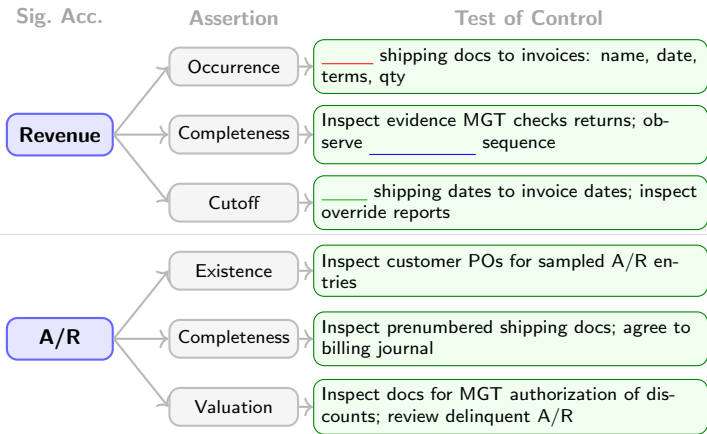
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### LO 7-5

Give examples of tests of controls in the revenue and collection cycle.



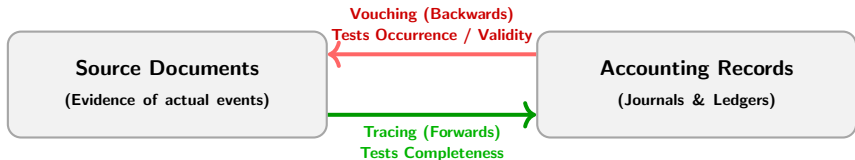
# Tests of Controls: Revenue and A/R<sup>7</sup>



<sup>7</sup>Based on Louwers Exhibit 7.8.

## Directional Testing: Vouching vs. Tracing

Auditors must perform **Two-Way Checking** (Directional Testing) between source documents and accounting records to fully verify a transaction cycle.



### Why is two-way checking required?

- Testing only one direction leaves the audit blind to the opposite risk.
- catches fake transactions (overstatements).
- catches forgotten transactions (understatements).

- 1 An auditor selects a sample of recorded sales entries from the sales journal and traces them back to shipping documents and customer purchase orders. This primarily tests the:
- A) Occurrence assertion for revenue
  - B) Completeness assertion for revenue
  - C) Valuation assertion for accounts receivable
  - D) Cutoff assertion for revenue
- 2 [T/F] Tracing from shipping documents to recorded sales transactions primarily tests the occurrence assertion.
- 3 [T/F] Dual-direction testing allows a single sample to provide evidence about both occurrence and completeness simultaneously.

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## LO 7-6

Give examples of substantive procedures in the revenue and collection cycle and relate them to assertions about account balances at the end of the period.

- For A/R, auditors emphasize the \_\_\_\_\_ assertion — the primary risk is **overstated** receivables.
- A/R confirmations are **required** by auditing standards unless:
  - ▶ A/R is **immaterial**, or
  - ▶ Confirmations would be **ineffective** (e.g., industry practice not to respond), or
  - ▶ **Sufficient evidence** is available from other procedures
- Even when confirmations are sent, they address primarily \_\_\_\_\_ and gross \_\_\_\_\_ — not collectability (valuation requires separate procedures).

<b>Procedure</b>	<b>Purpose / What It Signals</b>
Days Sales Outstanding (DSO) <sup>8</sup>	Assess collectability; detect unusual changes in collection patterns
Sales / A/R ratio	Compare to prior year and industry; large swings suggest recording issues
Gross margin analysis	Unexpected changes may indicate fictitious revenue or unrecorded returns
A/R aging schedule	Identify delinquent accounts; support the reasonableness of the allowance estimate

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<sup>8</sup>DSO =  $A/R \div (\text{Sales} \div 365)$ . Rising DSO may signal collection problems or fictitious receivables.

## Accounts Receivable Confirmations

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	Positive Confirmation	Negative Confirmation
Request	Reply <u>whether agree or disagree</u>	Reply <u>only if you disagree</u>
Response	Required; non-response = unreliable	Silence = presumed agreement
Evidence	Stronger	Weaker
Best for	Large / high-risk balances	Small balances; low control risk

Two common types of positive confirmations:

- 1 **Blank positive:** customer fills in the balance (strongest — no anchoring)
- 2 **Invoice positive:** auditor provides balance; customer confirms (most common)

### Non-responses (positive confirmations):

- Send a **second request**; if still no response, perform \_\_\_\_\_
- Non-response **is not evidence** that the balance is valid

### Common responses and follow-up:

Response	Follow-up Action
"Amount paid Dec. 31"	Treat as exception; verify check received after year-end
"Cannot confirm amount"	Treat as non-response; perform alternative procedures
"We returned items"	Discuss with client; verify no other unrecorded returns in receivables
"Goods received Jan. 3"	Likely late shipment; verify goods were removed from year-end inventory

### If unresolved:

- Estimate the dollar amount of the misstatement in the sample
- Project the misstatement to the full A/R population (sampling risk)
- Consider whether the pattern indicates **fraud**

### When customers do not respond:

- **Subsequent** \_\_\_\_\_ — most persuasive: customer paid after year-end<sup>9</sup>
- \_\_\_\_\_ — evidence the transaction occurred
- \_\_\_\_\_ documents— evidence goods were delivered
- Correspondence files — customer communications acknowledging the balance

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<sup>9</sup>The cash receipt should be traced to the remittance advice and the deposit into the client's cash account.

Dual-purpose procedures test both controls and account balances.

- \_\_\_\_\_ confirmations test both existence and controls over A/R recording.
- Reviewing \_\_\_\_\_ test both collectability (valuation) and controls over credit granting.

### Review for Collectability (Valuation assertion):

- Auditors evaluate the reasonableness of MGT's allowance for doubtful accounts:
  - ▶ Review A/R aging schedule — identify past-due accounts
  - ▶ Examine credit files for customers showing financial distress
  - ▶ Examine subsequent cash receipts and write-offs
  - ▶ Compare DSO to prior years and industry norms

### Sales Cutoff Test (Cutoff assertion):

- Compare shipping dates near year-end to invoice dates and recording dates
- Goods shipped before year-end but invoiced after → \_\_\_\_\_
- Goods shipped after year-end but invoiced before → \_\_\_\_\_
- Cutoff errors in revenue also affect inventory (goods still on hand vs. shipped)

## Practice Questions

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- 1 An auditor requests customers to confirm their A/R balance only if they disagree with the amount stated. This is a:
- A) Blank positive confirmation
  - B) Invoice positive confirmation
  - C) Negative confirmation
  - D) Alternative procedure
- 2 [T/F] When a customer does not respond to a positive confirmation request, this is sufficient evidence that the A/R balance is valid.
- 3 [T/F] Examining subsequent cash receipts is considered the most persuasive alternative procedure when a customer does not respond to a confirmation.

**Revenue cycle** = Orders → Shipping → Billing → Cash Collection.

<b>Topic</b>	<b>Key Takeaway</b>
Significant accounts	Revenue (occurrence, completeness, cutoff); A/R (existence, completeness, valuation)
Primary risk	MGT overstates revenue/A/R ⇒ <b>occurrence / existence</b> is the focus
Fraud presumption	AS 2110: presume improper revenue recognition in every audit
Internal controls	Segregation of duties + prenumbered docs + credit approval
Tests of controls	Inspect, reperform, observe — link to occurrence, completeness
Substantive tests	Confirmations (positive ≫ negative); cutoff; subsequent receipts