

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

Jaeyoon Yu, Ph.D.
Central Michigan University

Table of Contents

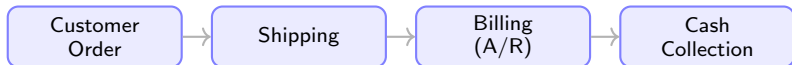
- 1 Revenue and Collection Cycle: Typical Activities
- 2 Significant Accounts and Relevant Assertions
- 3 Risk of Material Misstatement: Revenue Recognition
- 4 Internal Control Activities and Design Evaluation
- 5 Tests of Operating Effectiveness of Internal Control
- 6 Substantive Analytical Procedures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

LO 7-1

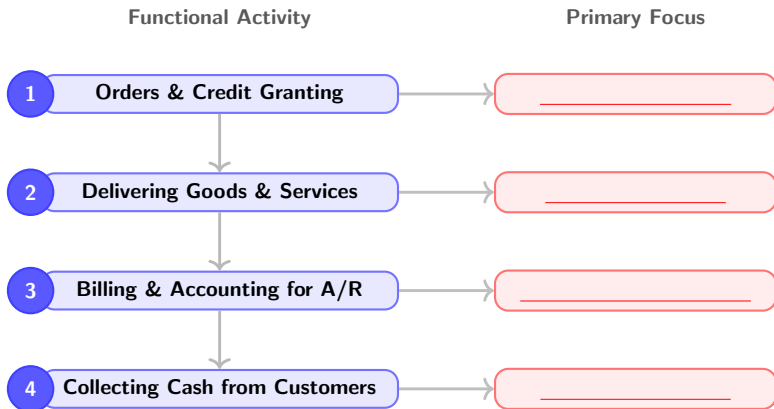
Describe the revenue and collection cycle, including typical source documents.

The Revenue and Collection Cycle

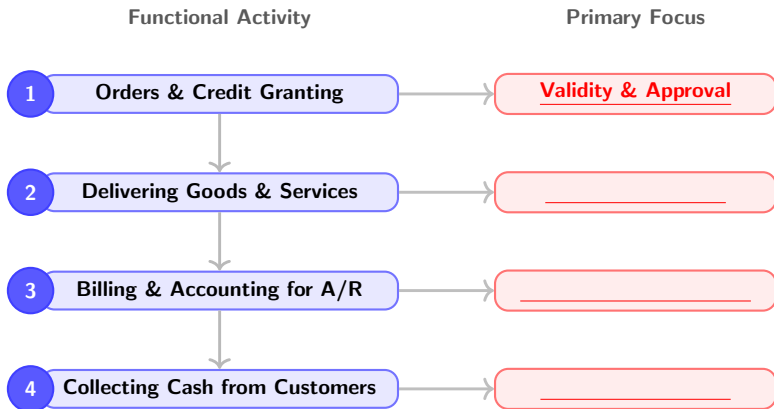
- The revenue and collection cycle encompasses all activities from customer order to cash collection.
- Auditors begin by understanding the cycle: activities, source documents, and how transactions flow through accounting systems.



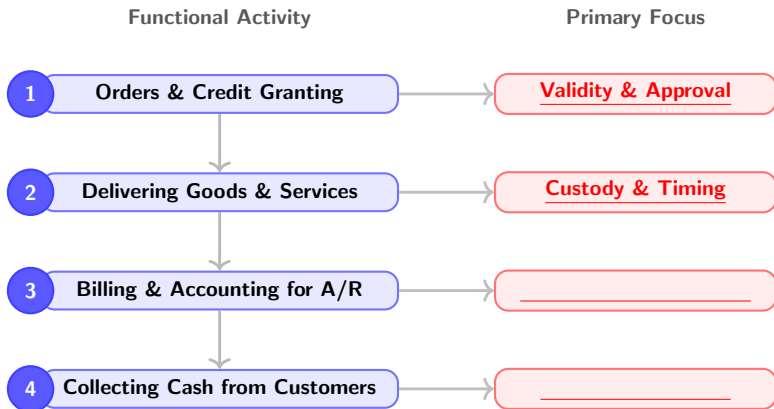
Four Functional Activities



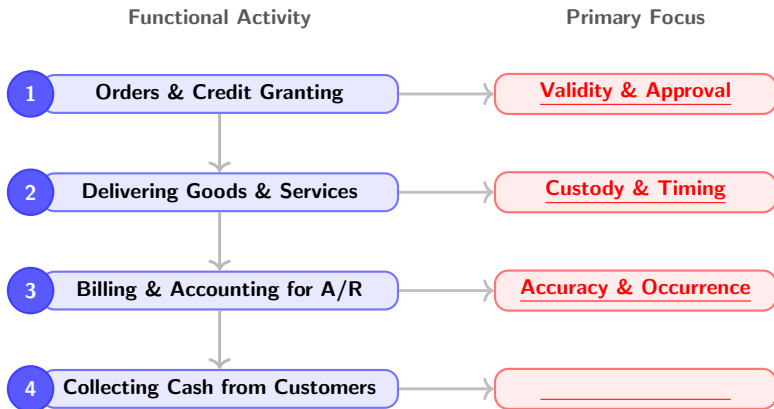
Four Functional Activities



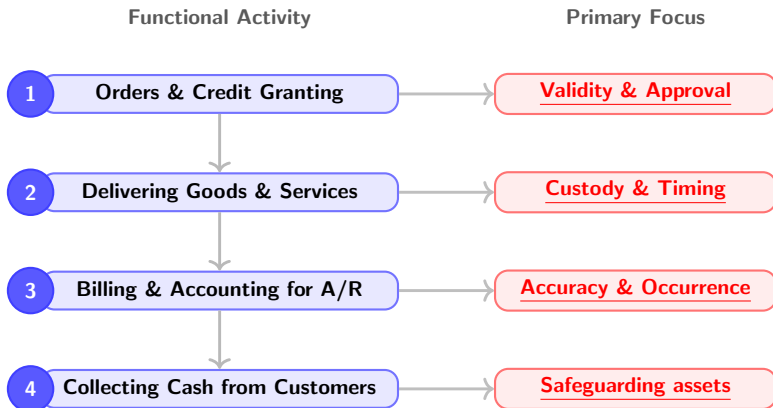
Four Functional Activities



Four Functional Activities



Four Functional Activities



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.

Phase Goal: Approving customers and initiating the transaction correctly.

Key Source Documents & Files

- **Customer Purchase Order (PO):** The external 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.

Phase Goal: Approving customers and initiating the transaction correctly.

Key Source Documents & Files

- **Customer Purchase Order (PO):** The external request from the customer.
- **Price Master File:** The system file of authorized prices.
- **Credit Application / Credit File:** Limits and approval history.
- **Sales Order:** The internal 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.

Phase Goal: Approving customers and initiating the transaction correctly.

Key Source Documents & Files

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

What Could Go Wrong?

- **Bad Debt:** Granting credit to non-creditworthy customers.
- Sales: Recording orders that were never actually placed.

Phase Goal: Approving customers and initiating the transaction correctly.

Key Source Documents & Files

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

What Could Go Wrong?

- **Bad Debt:** Granting credit to non-creditworthy customers.
- **Fictitious 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 **Customer Purchase Order (PO)** is a commercial document issued by a buyer 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 **Price Master File** is an internal master computer file containing authorized baseline prices for products. This limits employee ability to bill at **unauthorized** 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 credit application 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: APPROVED</i>

A **Credit Application** is submitted by the customer; the company's **Credit File** stores the **approved limit** 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	Excellent
<hr/>	
<i>New order total: \$10,000</i>	<i>Status: APPROVED</i>

A **Credit Application** is submitted by the customer; the company's **Credit File** stores the **approved limit** 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	\$37,600
Payment History	Excellent
<hr/>	
<i>New order total: \$10,000</i>	<i>Status: APPROVED</i>

A **Sales Order** is an _____ document generated by the company. It translates the customer's PO into a standardized format and is sequentially _____¹.

SALES ORDER (Internal)

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

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

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

A **Sales Order** is an **internal** document generated by the company. It translates the customer's PO into a standardized format and is sequentially **prenumbered**¹.

SALES ORDER (Internal)

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

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

¹Sequential 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.

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

Key Source Documents

- **Bill of Lading:** 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.

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

Key Source Documents

- **Bill of Lading:** Contract transferring custody to the carrier.
- **Packing Slip:** 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.

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

Key Source Documents

- **Bill of Lading:** Contract transferring custody to the carrier.
- **Packing Slip:** 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:** Misappropriation 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 **Bill of Lading** is a legally binding contract between the shipper (company) and the carrier (e.g., FedEx) transferring physical custody 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

A **Shipping Document** is an **internal** 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

A **Shipping Document** is an **internal** record prepared by the shipping department confirming that goods left the warehouse. It is sequentially **prenumbered** 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

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

A **Shipping Document** is an **internal** record prepared by the shipping department confirming that goods left the warehouse. It is sequentially **prenumbered** and links the physical shipment to the **sales order** and the **bill of lading**.

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.

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

Key Source Documents & Records

- **Sales Invoice:** 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.

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

Key Source Documents & Records

- **Sales Invoice:** The official bill sent to the customer requesting payment.
- **Sales Journal:** 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.

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

Key Source Documents & Records

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

What Could Go Wrong?

- **Occurrence:** Recording fictitious sales to inflate revenue.
- _____: Billing for an incorrect quantity or using the wrong price.

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

Key Source Documents & Records

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

What Could Go Wrong?

- **Occurrence:** Recording fictitious sales to inflate revenue.
- **Valuation:** 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
Total Due			\$10,000.00

The **Sales Invoice** is the official bill sent to the customer requesting payment. It combines the quantities 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
Total Due			\$10,000.00

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

SALES INVOICE

Bill To: ABC Retailers
Terms: 2/10, Net 30

Invoice #: INV-9901
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
Total Due			\$10,000.00

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 **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 **Occurrence** 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 **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 Occurrence and Completeness 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

The **A/R Subsidiary Ledger** tracks every individual client's running balance separately, ensuring we know exactly who owes what. 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

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.

Step 4: Collecting Cash from Customers

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

Key Source Documents

- **Remittance Advice:** 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.

Step 4: Collecting Cash from Customers

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

Key Source Documents

- **Remittance Advice:** Slip returned with the payment specifying the invoice.
- **Deposit Slip:** 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.

Step 4: Collecting Cash from Customers

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

Key Source Documents

- **Remittance Advice**: Slip returned with the payment specifying the invoice.
- **Deposit Slip**: Bank document listing cash and checks being deposited.
- **Cash Receipts Journal**: 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.

Step 4: Collecting Cash from Customers

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

Key Source Documents

- **Remittance Advice**: Slip returned with the payment specifying the invoice.
- **Deposit Slip**: Bank document listing cash and checks being deposited.
- **Cash Receipts Journal**: Listing of all daily cash/check intakes.

What Could Go Wrong?

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

Step 4: Collecting Cash from Customers

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

Key Source Documents

- **Remittance Advice**: Slip returned with the payment specifying the invoice.
- **Deposit Slip**: Bank document listing cash and checks being deposited.
- **Cash Receipts Journal**: Listing of all daily cash/check intakes.

What Could Go Wrong?

- **Theft**: Cash stolen upon arrival or in transit.
- **Lapping**: 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.

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

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

A **Remittance Advice** is usually a tear-off slip that the **customer** 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.

Customer Acct #	Paying Invoice #	Amount Enclosed
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
Total Deposit		\$13,000.00

A **Deposit Slip** is provided by the **bank** 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
Total Deposit		\$13,000.00

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

BANK DEPOSIT TICKET

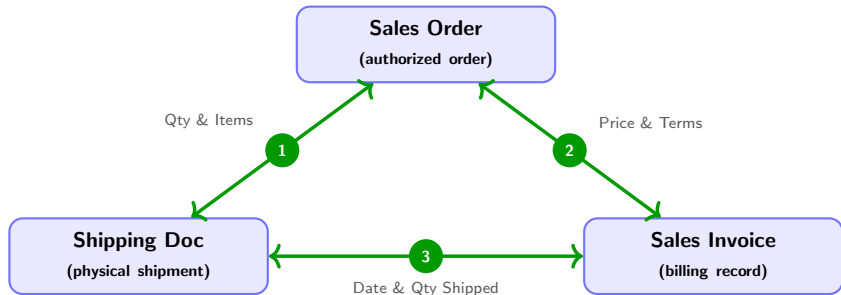
Account: XYZ Wholesale Operating

Date: Oct 8, 2026

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

Control: The 3-Way Match

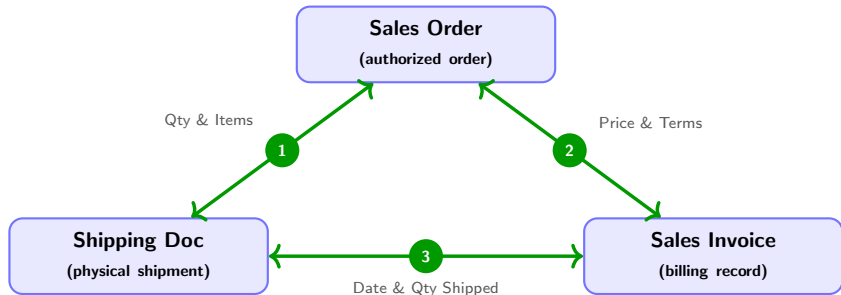
Auditors look for a robust **Three-Way Match** to ensure the _____ (Revenue) and _____ (A/R) assertions. Mismatches block the sale from being recorded.



- **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.

Control: The 3-Way Match

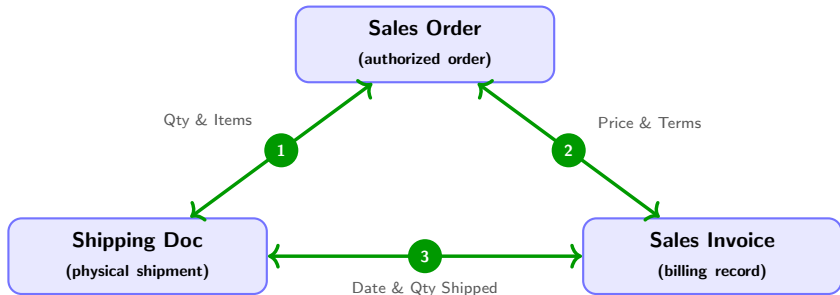
Auditors look for a robust **Three-Way Match** to ensure the **Occurrence** (Revenue) and _____ (A/R) assertions. Mismatches block the sale from being recorded.



- **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.

Control: The 3-Way Match

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

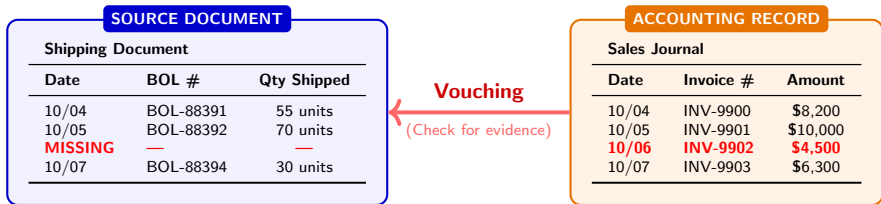


- **Match 1** (SO ↔ Shipping Doc): Ship only what the customer ordered.
- **Match 2** (SO ↔ Invoice): Bill at the price authorized on the sales order.
- **Match 3** (Shipping Doc ↔ Invoice): Bill only for what was physically shipped, on the correct date.

Audit Test: Vouching for Occurrence

Objective: Did the recorded sale actually take place?

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

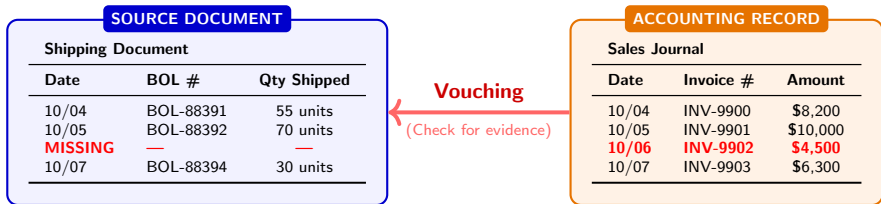


Audit Finding INV-9902 appears in the Sales Journal, but no matching BOL exists in the Shipping Document. _____ fails — this may be a _____ sale.

Audit Test: Vouching for Occurrence

Objective: Did the recorded sale actually take place?

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

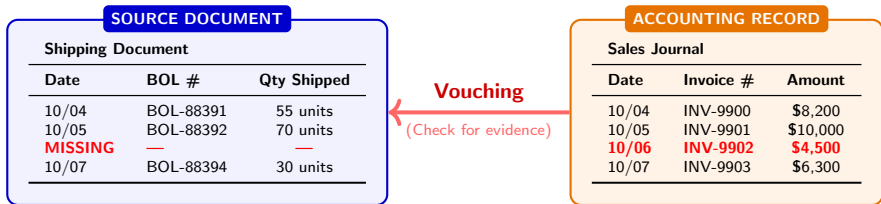


Audit Finding INV-9902 appears in the Sales Journal, but no matching BOL exists in the Shipping Document. **Occurrence** fails — this may be a _____ sale.

Audit Test: Vouching for Occurrence

Objective: Did the recorded sale actually take place?

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

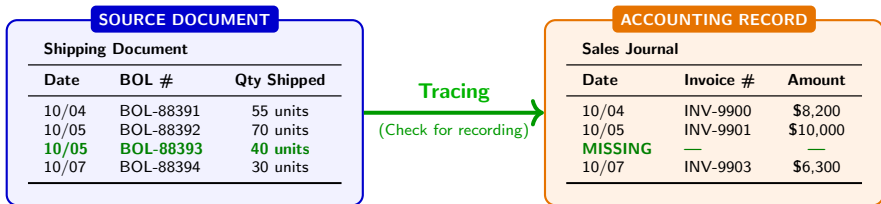


Audit Finding INV-9902 appears in the Sales Journal, but no matching BOL exists in the Shipping Document. **Occurrence** fails — this may be a **fictitious** sale.

Audit Test: Tracing for Completeness

Objective: Was everything that shipped actually billed?

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

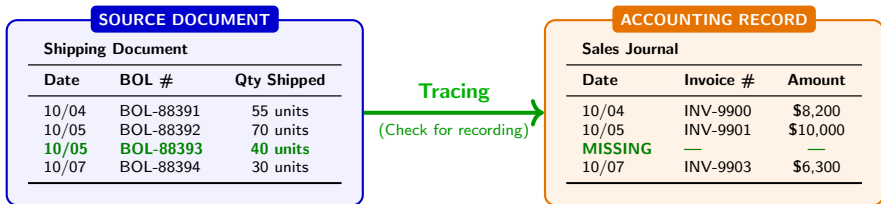


Audit Finding BOL-88393 appears in the Shipping Document, but no matching invoice exists in the Sales Journal. _____ fails — goods were shipped but never billed.

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. **Completeness** 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 billing²
- **Sales analysis reports** — periodic comparisons by product, region, or salesperson
- **A/R aging schedule** — lists balances by age; primary tool for evaluating collectability

²Exception reports flag invoices where the system could not match a price; auditors review these. ▶

- 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.

- 1 Which document provides primary evidence that a sale has been physically completed by shipping goods to the customer? **C**
- 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. **_**

- 1 Which document provides primary evidence that a sale has been physically completed by shipping goods to the customer? **C**
- 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. **T**
- 3 [T/F] The employee who has custody of cash should also be responsible for recording cash receipts in the journal. **_**

- 1 Which document provides primary evidence that a sale has been physically completed by shipping goods to the customer? **C**
- 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. **T**
- 3 [T/F] The employee who has custody of cash should also be responsible for recording cash receipts in the journal. **F**

Table of Contents

- 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 7-2

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

What Makes an Account Significant?

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.

What Makes an Account Significant?

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

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.

What Makes an Account Significant?

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

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

- 1 Set **audit risk** 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.

What Makes an Account Significant?

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

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

- ① Set **audit risk** at desired levels.
- ② Assess **RMM**:
 - ▶ *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.

What Makes an Account Significant?

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

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

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

Inherent Risk: Occurrence Over Completeness

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

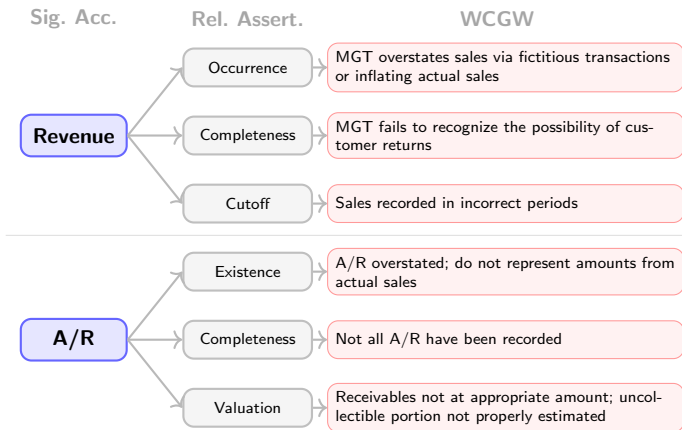
	Assertion	Risk Direction	Inherent Risk
Revenue	Occurrence	Overstatement	Higher
Revenue	Completeness	Understatement	Lower
A/R	Existence	Overstatement	Higher
A/R	Completeness	Understatement	Lower

Inherent Risk: Occurrence Over Completeness

Auditors generally presume MGT has an incentive to **overstate** revenue and A/R.

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

What Could Go Wrong? (WCGW)



Practice Questions

- 1 Recording sales in December for goods that were not shipped until January is a failure of which assertion?³
- 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.

³Choose the best one that describes the issue.

Practice Questions

- 1 Recording sales in December for goods that were not shipped until January is a failure of which assertion?³ **D**
- 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.

³Choose the best one that describes the issue.

Practice Questions

- 1 Recording sales in December for goods that were not shipped until January is a failure of which assertion?³ D
- 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. T
- 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. _

³Choose the best one that describes the issue.

- 1 Recording sales in December for goods that were not shipped until January is a failure of which assertion?³ **D**
- 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. **T**
- 3 [T/F] Fictitious sales recorded in the ledger represent a failure of the completeness assertion for revenue. **F**
- 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.
-

³Choose the best one that describes the issue.

- 1 Recording sales in December for goods that were not shipped until January is a failure of which assertion?³ **D**
- 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. **T**
- 3 [T/F] Fictitious sales recorded in the ledger represent a failure of the completeness assertion for revenue. **F**
- 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. **T**

³Choose the best one that describes the issue.

Table of Contents

- 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 7-3

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:

	Criterion	Key Audit Question
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 _____⁴
- ❷ If criterion 4 is not met, it is **channel stuffing**⁵

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

⁵a 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. 

When Is Revenue Earned? SEC Criteria


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

	Criterion	Key Audit Question
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?

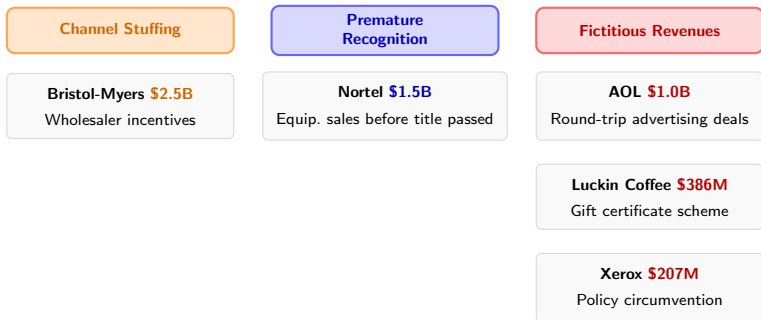
Failure of **any one** criterion means revenue should **not** be recognized.

- ❶ If criterion 2 is not met, it is **bill-and-hold**⁴
- ❷ If criterion 4 is not met, it is **channel stuffing**⁵

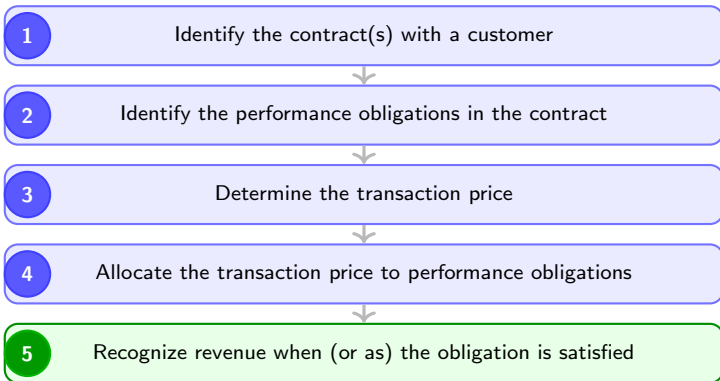
⁴a contract where a seller invoices a customer for goods but retains physical possession, often due to customer space constraints or production delays.

⁵a 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. 

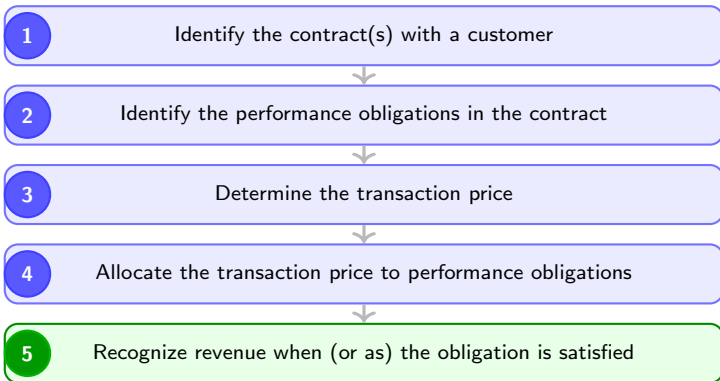
Revenue Recognition Rogues⁶



⁶Selected 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.



Key challenge: contracts with performance obligations — 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

- 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; valuation 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

- Customers generally have the right to return unused or unsold merchandise
- Companies must estimate **liabilities** 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

- Customers generally have the right to return unused or unsold merchandise
- Companies must estimate **liabilities** for returns, warranties, and contingent obligations at period end
- **Side agreements** — 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. __

- 1 Under AU-C 240, auditors must treat revenue recognition as a fraud risk: **C**
- 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. **__**

- 1 Under AU-C 240, auditors must treat revenue recognition as a fraud risk: **C**
- 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. **T**
- 3 [T/F] Under ASC 606, revenue is recognized when cash is received from the customer. **_**

- 1 Under AU-C 240, auditors must treat revenue recognition as a fraud risk: **C**
- 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. **T**
- 3 [T/F] Under ASC 606, revenue is recognized when cash is received from the customer. **F**

Table of Contents

- 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 7-4

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

- 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.

Entity-Level Controls

- 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 **overstate** revenue.
- MGT should have a process to continually review _____ (unusual or unexpected items).
- MGT should actively monitor ____: aging, uncollectible ratios, and timeliness of collections.

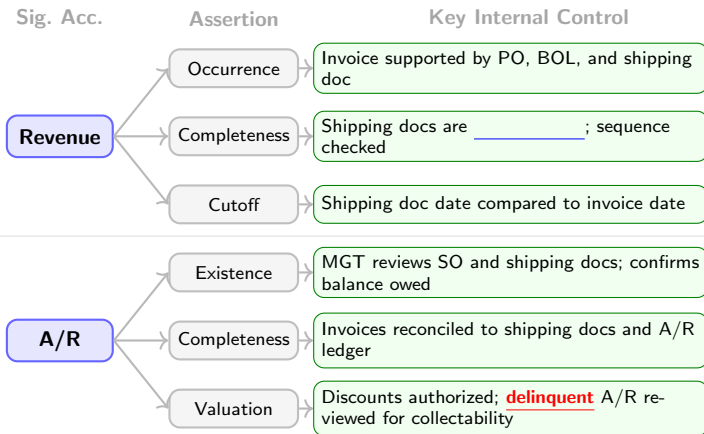
Entity-Level Controls

- 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 **overstate** revenue.
- MGT should have a process to continually review **exceptions** (unusual or unexpected items).
- MGT should actively monitor ____ : aging, uncollectible ratios, and timeliness of collections.

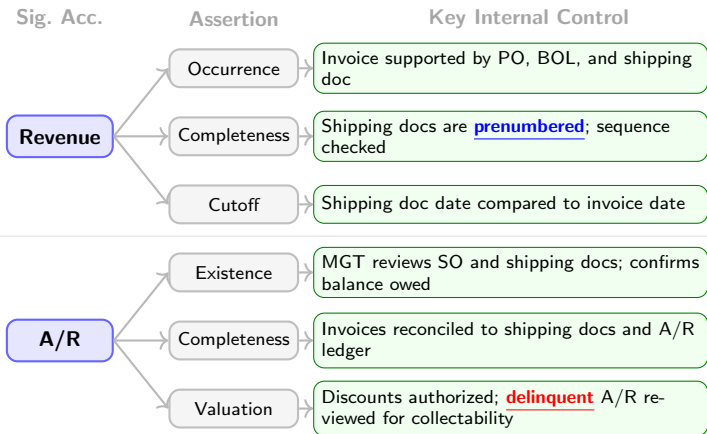
Entity-Level Controls

- 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 **overstate** revenue.
- MGT should have a process to continually review **exceptions** (unusual or unexpected items).
- MGT should actively monitor **A/R**: aging, uncollectible ratios, and timeliness of collections.

Key Control Activities by Assertion

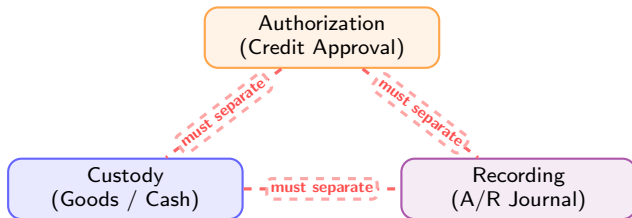


Key Control Activities by Assertion



Separation of Duties

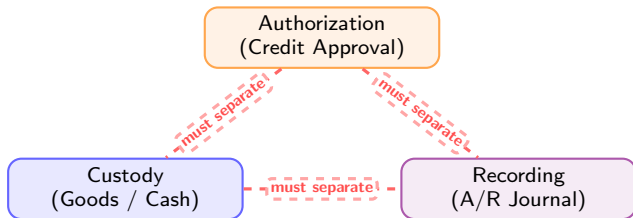
The most critical entity-level control in the revenue cycle is _____.



- **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.

Separation of Duties

The most critical entity-level control in the revenue cycle is separation of duties.



- **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.

Control Walkthrough

- 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.

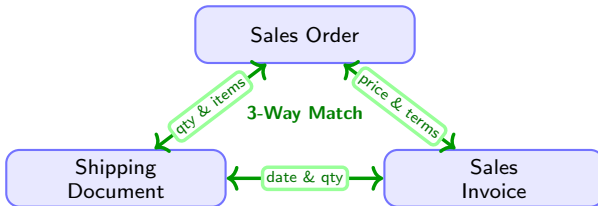
Control Walkthrough

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

Control Walkthrough

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

Three-Way Match



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.

- 1 Which control best mitigates the risk of recording sales in incorrect periods (cutoff assertion)? **B**
- 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.

- 1 Which control best mitigates the risk of recording sales in incorrect periods (cutoff assertion)? **B**
- 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. **F**
- 3 [T/F] In small businesses where separation of duties is impractical, the owner's active involvement can serve as a compensating control. **__**

- 1 Which control best mitigates the risk of recording sales in incorrect periods (cutoff assertion)? **B**
- 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. **F**
- 3 [T/F] In small businesses where separation of duties is impractical, the owner's active involvement can serve as a compensating control. **T**

Table of Contents

- 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 7-5

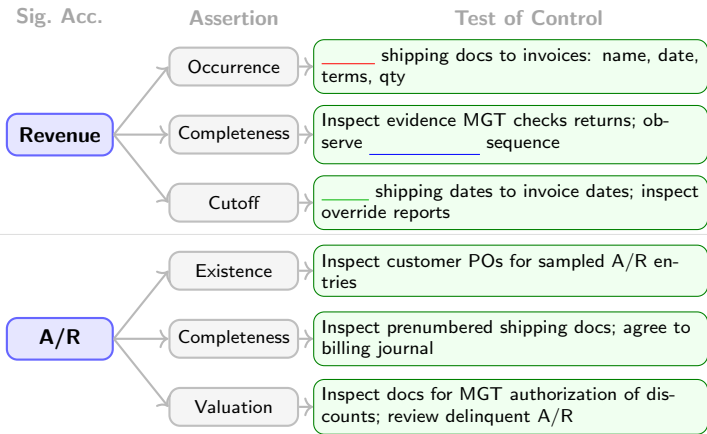
Give examples of tests of controls in the revenue and collection cycle.

- : control exists and is designed to prevent/detect misstatements — assessed via *walkthrough*.
- : control is actually working throughout the period — assessed via tests of controls.

- **Design effectiveness**: control exists and is designed to prevent/detect misstatements — assessed via *walkthrough*.
- _____ : control is actually working throughout the period — assessed via tests of controls.

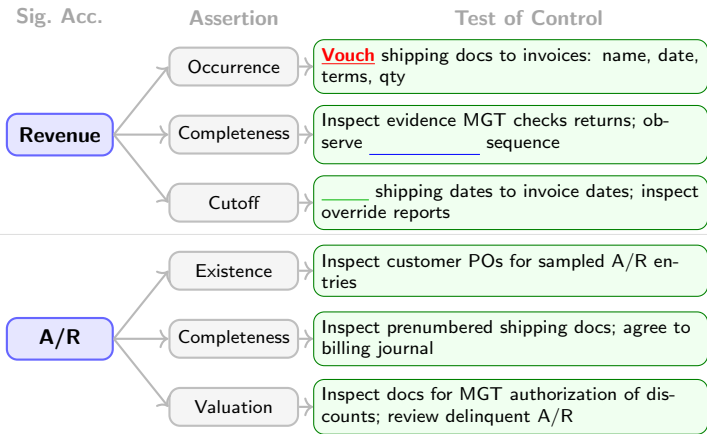
- **Design effectiveness**: control exists and is designed to prevent/detect misstatements — assessed via *walkthrough*.
- **Operating effectiveness**: control is actually working throughout the period — assessed via tests of controls.

Tests of Controls: Revenue and A/R⁷



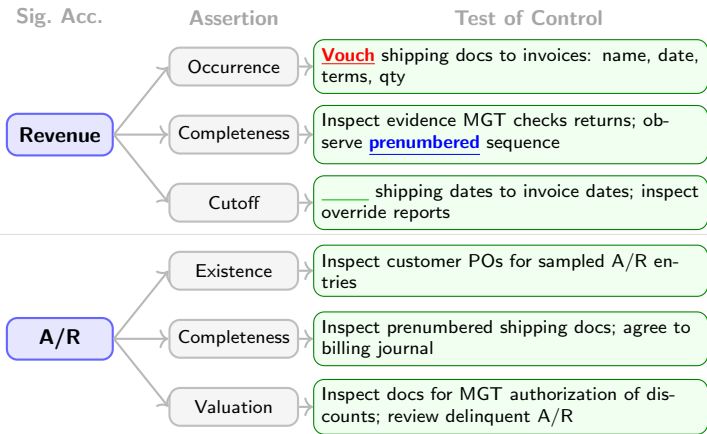
⁷Based on Louwers Exhibit 7.8.

Tests of Controls: Revenue and A/R⁷



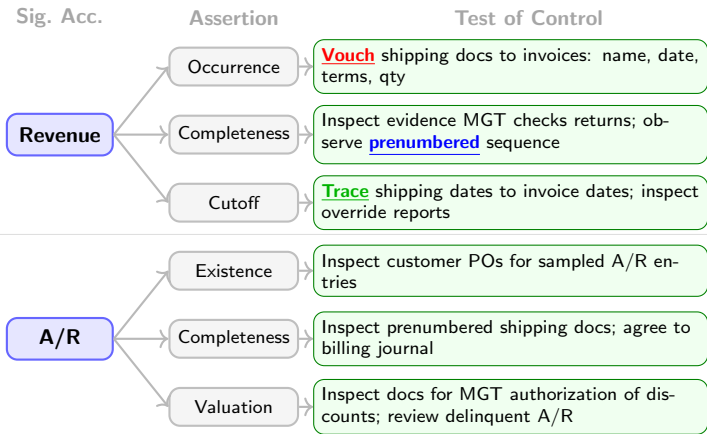
⁷Based on Louwers Exhibit 7.8.

Tests of Controls: Revenue and A/R⁷



⁷Based on Louwers Exhibit 7.8.

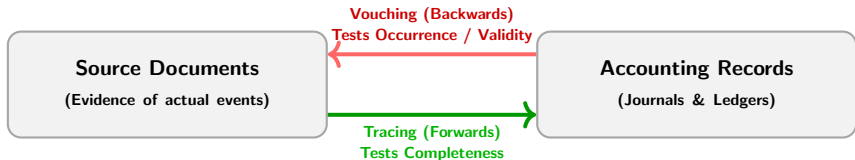
Tests of Controls: Revenue and A/R⁷



⁷Based 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.

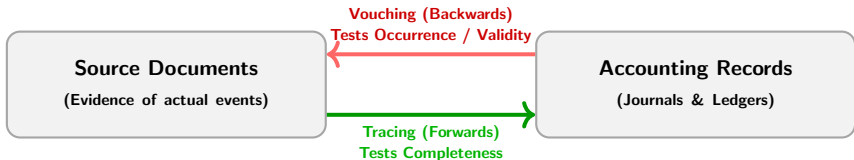


Why is two-way checking required?

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

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.

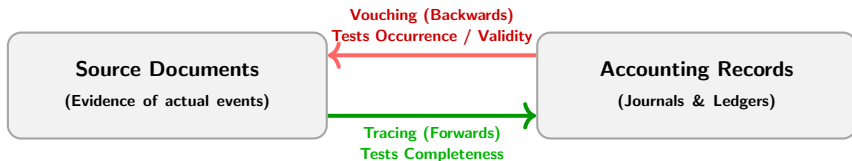


Why is two-way checking required?

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

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.
- **Vouching** catches fake transactions (overstatements).
- **Tracing** 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.

- 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**
- 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.

- 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**
- 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. **F**
- 3 [T/F] Dual-direction testing allows a single sample to provide evidence about both occurrence and completeness simultaneously. **—**

- 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**
 - 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. **F**
- 3 [T/F] Dual-direction testing allows a single sample to provide evidence about both occurrence and completeness simultaneously. **T**

Table of Contents

- 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 7-6

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).

- For A/R, auditors emphasize the **existence** 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).

- For A/R, auditors emphasize the existence 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 existence and gross _____ — not collectability (valuation requires separate procedures).

- For A/R, auditors emphasize the existence 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 existence and gross valuation — not collectability (valuation requires separate procedures).

Procedure	Purpose / What It Signals
Days Sales Outstanding (DSO) ⁸	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

⁸DSO = $A/R \div (Sales \div 365)$. Rising DSO may signal collection problems or fictitious receivables.

Accounts Receivable Confirmations

	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**

Non-responses (positive confirmations):

- Send a [second request](#); if still no response, perform [alternative procedures](#)
- 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-end⁹
- _____ — evidence the transaction occurred
- _____ documents— evidence goods were delivered
- Correspondence files — customer communications acknowledging the balance

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


When customers do not respond:

- Subsequent cash receipts — most persuasive: customer paid after year-end⁹
- _____ — evidence the transaction occurred
- _____ documents— evidence goods were delivered
- Correspondence files — customer communications acknowledging the balance

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


When customers do not respond:

- **Subsequent cash receipts** — most persuasive: customer paid after year-end⁹
- **Sales orders and invoices** — evidence the transaction occurred
- documents— evidence goods were delivered
- Correspondence files — customer communications acknowledging the balance

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

When customers do not respond:

- **Subsequent cash receipts** — most persuasive: customer paid after year-end⁹
- **Sales orders and invoices** — evidence the transaction occurred
- **Shipping** documents— evidence goods were delivered
- Correspondence files — customer communications acknowledging the balance

⁹The 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.

Dual-purpose procedures test both controls and account balances.

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

Dual-purpose procedures test both controls and account balances.

- A/R confirmations test both existence and controls over A/R recording.
- Reviewing credit files 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)

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 → understated revenue
- Goods shipped after year-end but invoiced before → _____
- Cutoff errors in revenue also affect inventory (goods still on hand vs. shipped)

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 → understated revenue
- Goods shipped after year-end but invoiced before → premature recognition
- Cutoff errors in revenue also affect inventory (goods still on hand vs. shipped)

- 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.

- 1 An auditor requests customers to confirm their A/R balance only if they disagree with the amount stated. This is a: **C**
- 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. **_**

- 1 An auditor requests customers to confirm their A/R balance only if they disagree with the amount stated. This is a: **C**
- 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. **F**
- 3 [T/F] Examining subsequent cash receipts is considered the most persuasive alternative procedure when a customer does not respond to a confirmation. **__**

Practice Questions

- 1 An auditor requests customers to confirm their A/R balance only if they disagree with the amount stated. This is a: **C**
- 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. **F**
- 3 [T/F] Examining subsequent cash receipts is considered the most persuasive alternative procedure when a customer does not respond to a confirmation. **T**

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

Topic	Key Takeaway
Significant accounts	Revenue (occurrence, completeness, cutoff); A/R (existence, completeness, valuation)
Primary risk	MGT overstates revenue/A/R ⇒ occurrence / existence 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