Professional Education Services, LP

Quality education offered by PES...

Introduction to Fraud in Cash Collections and Disbursements

Course #6180B/QAS6180B

Course Material

Professional Education Services, LP

The Professional's Choice for CPE. sm

4208 Douglas Blvd. • Suite 50 • Granite Bay, CA 95746

To Order: 1-800-998-5024 • Customer Service: 1-800-990-2731 • Fax: 916-791-4099

www.mypescpe.com • www.pescpe.com • www.pesqascpe.com • www.eacpe.com

Introduction to Fraud in Cash Collections and Disbursements

Course #6180B/QAS6180B

NOTICE

This course and test have been adapted with permission from material written by Dr. Jack Robertson, PhD, CPA, CFE as presented in the text *Fraud Examination for Managers and Auditors.* This course is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional advice and assumes no liability whatsoever in connection with its use. Since tax laws are constantly changing, and are subject to differing interpretations, we urge you to do additional research and consult appropriate experts before relying on the information contained in this course to render professional advice.

No portion of this work may be reproduced or transmitted in any form or by any means electronic or mechanical, including photocopying, recording, or by any information storage and retrieval system without the written permission of the publisher.

© Professional Education Services, LP 2012

Introduction to Fraud in Cash Collections and Disbursements (Course #6180B/QAS6180B)

Table of Contents

Chapter 1: Cash Collections and Receivables

Revenue and Collection Cycle: Typical Activities 1-1
Audit Evidence in Management Reports and Data Files 1-6
Special Note: The Existence Assertion 1-7
Special Note: Using Confirmations 1-9
Special Note: Audit of Bank Reconciliations with Attention to Lapping and Kiting 1-16
Bank Transfer Schedule and "Proof of Cash" 1-21
Audit Cases: Substantive Audit Procedures 1-23
Case 1.1: The Canny Cashier 1-25
Case 1.2: The Taxman Always Rings Twice 1-28
Case 1.3: Bill Often, Bill Early 1-31
Case 1.4: Thank Goodness It's Friday 1-34
Review Questions & Solutions 1-38

Chapter 2: Cash Disbursements and Payables

Acquisition and Expenditure Cycle: Typical Activities 2-1
Audit Evidence in Management Reports 2-4
Special Note: The Completeness Assertion – Search for Unrecorded Liabilities 2-6
Special Note: Physical Inventory Observation 2-8
Audit Cases: Substantive Audit Procedures 2-11
Case 2.1: Printing (Copying) Money 2-13
Case 2.2: Real Cash Paid to Phony Doctors 2-16
Case 2.3: Receiving the Missing Oil 2-19
Case 2.4: Go For the Gold 2-22
Case 2.5: Retread Tires 2-25
Case 2.6: Amortize *Bang the Drum* Slowly 2-28
Case Study: Like A Son 2-33
Case Study: The Bulging Desk Drawers 2-36
Case Study: Audit Approach 2-39
Review Questions & Solutions 2-42

Glossary

Index

Chapter 1: Cash Collections and Receivables

The revenue and collection accounting cycle covers sales, sales returns, accounts receivable, account write-offs, and cash collections. This chapter contains sections on:

(1) typical control activities in the cycle
(2) the audit evidence available in management reports and data files, and
(3) case story-style explanations concerning discovery of errors and frauds.

Special notes in the chapter cover:

(1) the existence assertion,
(2) using confirmations,
(3) bank reconciliation with attention to lapping and kiting, and
(4) bank transfer and proof of cash analyses.

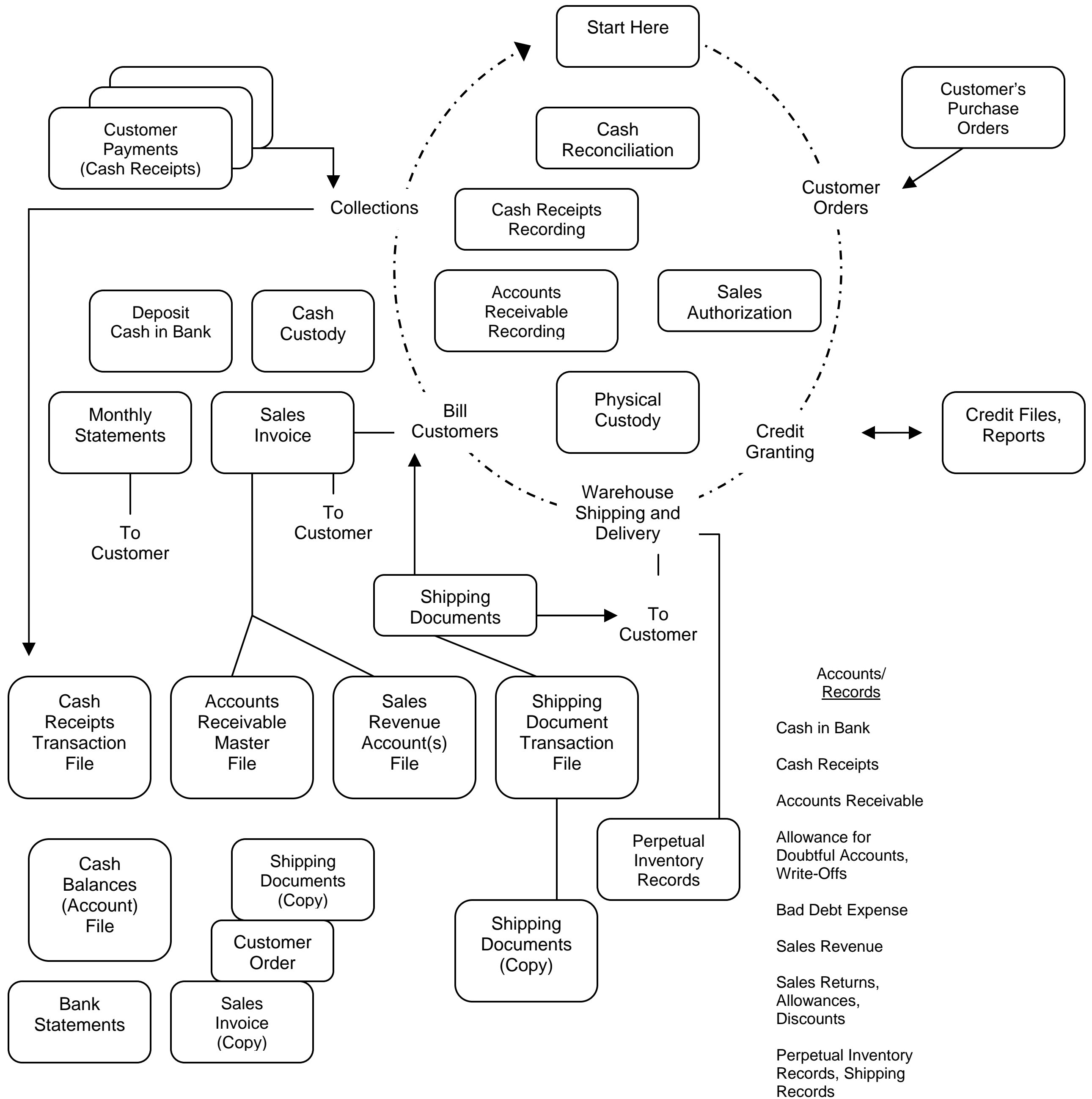
REVENUE AND COLLECTION CYCLE: TYPICAL ACTIVITIES

The basic activities in the revenue and collection cycle are:

(1) receiving and processing customer orders, including credit granting;
(2) delivering goods and services to customers;
(3) billing customers and accounting for accounts receivable;
(4) collecting and depositing cash received from customers; and
(5) reconciling bank statements.

Exhibit 1-1 shows the activities and transactions involved in a revenue and collection cycle. As you follow the exhibit, you can track some of the elements of a control system.

EXHIBIT 1-1 Revenue and Collection Cycle



SALES AND ACCOUNTS RECEIVABLE

Authorization

In a computerized system for processing customer orders, Company personnel receive the customer's purchase order and create a sales order, entering it in a computer terminal. The computer system then performs automatic authorization procedures--determining whether the customer is a "regular" or a new customer, approving credit, and checking the availability of inventory to fill the order. (If inventory is short, a back order is entered.) When these authorizations are imbedded in a computer system, access to the master files for additions, deletions, and other changes must be limited to responsible persons. If these controls fail, orders might be processed for fictitious customers, credit might be approved for bad credit risks, and packing slips might be created for goods that do not exist in the inventory.

When a customer order passes these authorizations, the system: (1) creates a record in the pending order master file, (2) produces a packing slip that is transmitted to the stockroom and shipping department, and (3) updates the inventory master file to show the commitment (removal) of the inventory. At this stage, the pending order and the packing slip should be numbered in a numerical sequence so the system can determine later whether any transactions have not been completed (completeness objective of control). The packing slip is the storekeeper's authorization to release goods to the shipping department and the shipping department's authorization to release goods to a trucker or to the customer.

Another authorization in the system is the price list master file. It contains the product unit prices for billing customers. Persons who have power to alter this file have the power to authorize price changes and customer billings.

PRICE MANIPULATION

The company's computer programmer was paid off by a customer to cause the company to bill the customer at prices lower than list prices. The programmer wrote a subroutine that was invoked when the billing system detected the customer's regular code number. This subroutine instructed the computer billing system to reduce all unit prices 9.5 percent. The company relied on the computer billing system, and nobody ever rechecked the actual prices billed.

Custody

Physical custody of goods starts with the storeroom or warehouse where inventory is kept. Custody is transferred to the shipping department upon the authorization of the packing slip that orders storekeepers to release goods to the shipping area. As long as the system works, custody is under accountability control. However, if the storekeepers or the shipping department personnel have the power to change the quantity shown on the packing slip, they can cause errors in the system by billing the customer for too small or too large a quantity. (This power combines custody with a recording function. A computer record or "log" of such changes will create an electronic paper trail.)

"Custody" of accounts receivable records themselves implies the power to alter them directly or enter transactions to alter them (e.g., transfers, returns and allowance credits, write-offs). Personnel with this power have a combination of authorization and recording responsibility. (A computer "log" of such entries will create an electronic paper trail.)

Recording

When delivery or shipment is complete, the shipping personnel enter the completion of the transaction in a terminal, and the system (1) produces a bill of lading shipping document, which is evidence of an actual delivery/shipment; (2) removes the order from the pending order master file; and (3) produces a sales invoice (prenumbered the same as the order and packing slip) that bills the customer for the quantity shipped, according to the bill of lading. Any personnel who have the power to enter or alter these transactions or to intercept the invoice that is supposed to be mailed to the customer have undesirable combinations of authorization, custody, and recording responsibilities; they can "authorize" transaction changes and record them by making entries in systems under their control.

SHIPPING EMPLOYEE CAUGHT BY COMPUTER!

A customer paid off a shipping department employee to enter smaller quantities than actually shipped on the packing slip and bill of lading. This caused the customer's invoices to be understated. Unknown to the employee, a computer log recorded all the entries that altered the original packing slip record. An alert internal auditor noticed the pattern of "corrections" made by the shipping employee. A trap was laid by initiating fictitious orders for this customer, and the employee was observed making the alterations.

Periodic Reconciliation

The most frequent reconciliation is the comparison of the sum of customers' unpaid balances with the accounts receivable control account total. Usually, this reconciliation is done with an aged trial balance. An aged trial balance is a list of the customers and their balances, with the balances classified in columns headed for different age categories (e.g., current, 10-30 days past due, 31-60 days past due, 61-90 days past due, over 90 days past due). Internal auditors can perform periodic comparison of the customers' obligations (according to the customers) with the recorded amount by sending confirmations to the customers. (Refer to the special note on confirmations later in this chapter.)

CASH RECEIPTS AND CASH BALANCES

Authorization

Cash can be received in several ways – over the counter, through the mail, by electronic funds transfer, and by receipt in a "lockbox." In a lockbox arrangement, a fiduciary (e.g., a bank) opens the box, lists the receipts, deposits the money, and sends the remittance advices (stubs showing the amount received from each customer) to the company. Most companies need little "authorization" to accept a payment from a customer! However, authorization is important for approving customers' discounts and allowances taken, claiming to pay the bill in full.

Custody

Someone always gets the cash and checks in hand and thus has custody of the physical cash for a time. Control over this custody can vary. Companies can rotate people through the custody responsibility so one person does not have this custody all the time; they can have rotating teams of two or more people so they would need to collude with one another to steal money; they can make arrangements outside the company for actual cash custody (e.g., the lockbox arrangement). Since this initial custody cannot be avoided, it is always good control to prepare a list of the cash receipts as early in the process as possible, then separate the actual cash from the bookkeeping documents. The cash goes to the cashier or treasurer's office, where a bank deposit is prepared and the money is sent to the bank. The list goes to the accountants, who record the cash receipts. (This list may be only a stack of the remittance advices received with the customers' payments. You yourself prepare a "remittance advice" each time you write the "amount enclosed" on the top part of your credit card billing, tear it off, and enclose it with your check.)

Recording

The accountants who record cash receipts and credits to customer accounts should not handle the cash. They should use the remittance list to make entries to the cash and accounts receivable control accounts and to the customers' accounts receivable subsidiary account records. In fact, a good error-checking activity is to have control account and subsidiary account entries made by different people, then later the accounts receivable entries and balances can be compared (reconciled) to determine whether the proper source documents (remittance lists) were used to make error-free accounting entries. Some computerized accounting programs post the customers' accounts automatically by keying on the customer identification number.

Periodic Reconciliation

Bank account reconciliations should be prepared carefully. Deposit slips should be compared to the details on cash remittance lists, and the total should be traced to the general ledger entries. Likewise, paid checks should be traced to the cash disbursements listing (journal). This care is required to establish that all the receipts recorded in the books were deposited and that credit was given to the right customer. (Refer to the special note on auditing bank reconciliations later in this chapter.)

CAREFUL RECONCILIATION

Suppose the cashier who prepares the remittance list had stolen and converted Customer A's checks to personal use. It might work for a short time until Customer A complained that the company had not given credit for payments. The cashier knows this. So, the cashier later puts Customer B's check in the bank deposit, but shows Customer A on the remittance list; thus, the accountants give Customer A credit. So far, so good for preventing Customer A's complaint. But now Customer B needs to be covered. This "lapping" of customer payments to hide an embezzlement can be detected by a bank reconciliation comparison of the checks deposited (Customer B) with the remittance credit recorded (Customer A).

AUDIT EVIDENCE IN MANAGEMENT REPORTS AND DATA FILES

Computer processing of revenue and cash receipts transactions makes it possible for management to generate several reports that can provide important audit evidence. Auditors should obtain and use these reports.

PENDING ORDER MASTER FILE

This file contains sales transactions that were started in the system but are not yet completed, thus not recorded as sales and accounts receivable. Old orders may represent shipments that actually were made, but for some reason the shipping department did not enter the shipping information (or entered an incorrect code that did not match the pending order file). The pending orders can be reviewed for evidence of the *completeness* of recorded sales and accounts receivable.

CREDIT CHECK FILES

The computer system may make automatic credit checks, but up-to-date maintenance of the credit information is very important. Credit checks on old or incomplete information are not good credit checks. A sample of the files can be tested for current status. Alternatively, the company's records on updating the files can be reviewed for evidence of updating operations.

PRICE LIST MASTER FILE

The computer system may produce customer invoices automatically; but, if the master price list is wrong, the billings will be wrong. The computer file can be compared to an official price source for accuracy. (The company should perform this comparison every time the prices are changed.)

SALES DETAIL (SALES JOURNAL) FILE

This file should contain the detail sales entries, including the shipping references and dates. The file can be scanned for entries without shipping references (fictitious sales?) and for match of recording dates with shipment dates (sales recorded before shipment?). This file contains the population of debit entries to the accounts receivable.

SALES ANALYSIS REPORTS

A variety of sales analyses may be produced. Sales classified by product lines is information for the business segment disclosures. Sales classified by sales employee or region can show unusually high or low volume that might bear further investigation if error or fraud is suspected.

ACCOUNTS RECEIVABLE AGED TRIAL BALANCE

This list of customers' accounts receivable balances is the accounts receivable. If the control account total is larger than the sum in the trial balance, too bad. A receivable amount that cannot be identified with a customer cannot be collected! The trial balance is used as the population for selecting accounts for confirmation. (See the special note on the existence assertion and the special note on using confirmations later in this chapter.) The aging information is used in connection with assessing the allowance for doubtful accounts.

CASH RECEIPTS JOURNAL

The cash receipts journal contains all the detail entries for cash deposits and credits to various accounts. It contains the population of credit entries that should be reflected in the credits to accounts receivable for customer payments. It also contains the adjusting and correcting entries that can result from the bank account reconciliation. These entries are important because they may signal the types of accounting errors or manipulations that happen in the cash receipts accounting.

PEAKS AND VALLEYS

During the year-end audit, the independent auditors reviewed the weekly sales volume reports classified by region. They noticed that sales volume was very high in Region 2 the last two weeks of March, June, September, and December. The volume was unusually low in the first two weeks of April, July, October, and January. In fact, the peaks far exceeded the volume in all the other six regions. Further investigation revealed that the manager in Region 2 was holding open the sales recording at the end of each quarterly reporting period in an attempt to make the quarterly reports look good.

SPECIAL NOTE: THE EXISTENCE ASSERTION

When considering assertions and obtaining evidence about accounts receivable and other assets, auditors must put emphasis on the existence and rights (ownership) assertions. (For liability accounts, the emphasis is on the completeness and obligations assertions, as explained in Chapter 2.) This emphasis on existence is rightly placed because companies and auditors often have gotten into malpractice trouble by giving unqualified reports on financial statements that overstated assets and revenues and understated expenses. For example, credit sales recorded too early (fictitious sales?) result in overstated accounts receivable and overstated sales revenue; failure to amortize prepaid expense results in understated expenses and overstated prepaid expenses (current assets).

Discerning the population of assets to audit for existence and ownership is easy because the company has *asserted* their existence by putting them on the balance sheet. The audit procedures described in the following sections can be used to obtain evidence about the existence and ownership of accounts receivable and other assets.

RECALCULATION

Think about the assets that depend largely on calculations. They are amenable to auditors' recalculation procedures. Expired prepaid expenses are recalculated, using auditors' vouching of basic documents, such as loan agreements (prepaid interest), rent contracts (prepaid rent), and insurance policies (prepaid insurance). Goodwill and deferred expenses are recalculated by using original acquisition and payment document information and term (useful life) estimates. A bank reconciliation is a special kind of calculation, and the company's reconciliation can be audited. (See the special note on auditing a bank reconciliation later in this chapter.)

PHYSICAL OBSERVATION

Inventories and fixed assets can be inspected and counted (more on inventory observation is in Chapter 2). Titles to autos, land, and buildings can be vouched, sometimes using public records in the county clerk's office. Petty cash and undeposited receipts can be observed and counted, but the cash in the bank cannot. Securities held as investments can be inspected if held by the company.

CONFIRMATION

Letters of confirmation can be sent to banks and customers, asking for a report of the balances owed the company. Likewise, if securities held as investments are in the custody of banks or brokerage houses, the custodians can be asked to report the names, numbers, and quantity of the securities held for the company. In some cases, inventories held in public warehouses or out on consignment can be confirmed with the other party. (Refer to the special note on confirmations later in this chapter.)

VERBAL INQUIRY

Inquiries to management usually do not provide very convincing evidence about existence and ownership. However, inquiries always should be made about the company's agreements to maintain compensating cash balances (may not be classifiable as "cash" among the current assets), about pledge or sale of accounts receivable with recourse in connection with financings, and about pledge of other assets as collateral for loans.

EXAMINATION OF DOCUMENTS (VOUCHING)

Evidence of ownership can be obtained by studying the title documents for assets. Examination of loan documents may yield evidence of the need to disclose assets pledged as loan collateral.

SCANNING

Assets are supposed to have debit balances. A computer can be used to scan large files of accounts receivable, inventory, and fixed assets for uncharacteristic credit balances. Usually, such credit balances reflect errors in the recordkeeping – customer overpayments, failure to post purchases of inventory, depreciation of assets more than cost. The names of debtors can be scanned for officers, directors, and related parties, amounts which need to be reported separately or disclosed in the financial statements.

ANALYTICAL PROCEDURES

A variety of analytical comparisons might be employed, depending on the circumstances and the nature of the business. Comparisons of asset and revenue balances with recent history might help detect overstatements. Such relationships as receivables turnover, gross margin ratio, and sales/asset ratios can be compared to historical data and industry statistics for evidence of overall reasonableness. Account interrelationships also can be used in analytical review. For example, sales returns and allowances and sales commissions generally vary directly with dollar sales volume, bad debt expense usually varies directly with credit sales volume, and freight expense varies with the physical sales volume. Accounts receivable write-offs should be compared with earlier estimates of doubtful accounts.

SIMPLE ANALYTICAL COMPARISON

The auditors prepared a schedule of the monthly credit sales totals for the current and prior years. They noticed several variations, but one, in November of the current year, stood out in particular. The current-year credit sales were almost twice as large as any prior November. Further investigation showed that a computer error had caused the November credit sales to be recorded twice in the control accounts. The accounts receivable and sales revenue were materially overstated as a result.

SPECIAL NOTE: USING CONFIRMATIONS

This special note gives some details about using confirmations in the audit of cash and accounts receivable. In general, the use of confirmations for cash balances and trade accounts receivable is considered a required generally accepted audit procedure (SAS 67, AU 330). However, auditors may decide not to use them if suitable alternative procedures are available and applicable in particular circumstances. Auditors should document justifications for the decision not to use confirmations for trade accounts receivable in a particular audit. Justifications include:

(1) receivables are not material;

(2) confirmations would be ineffective, based on prior years' experience or knowledge that responses could be unreliable; and

(3) analytical procedures and other substantive test of details procedures provide sufficient, competent evidence.

A DECISION NOT TO USE ACCOUNTS RECEIVABLE CONFIRMATIONS

Sureparts Manufacturing Company sold all its production to three auto manufacturers and six aftermarket distributors. All nine of these customers typically paid their accounts in full by the 10th of each following month. The auditors were able to vouch the cash receipts for the full amount of the accounts receivable in the bank statements and cash receipts records in the month following the Surepart year-end. Confirmation evidence was not considered necessary in these circumstances.

CONFIRMATION OF CASH AND LOAN BALANCES

The standard bank confirmation form, approved by the AICPA, the American Bankers Association, and the Bank Administration Institute, is shown in Exhibit 1-2. Auditors use this form to obtain bank confirmation of deposit and loan balances. (Other confirmation letters are used to obtain confirmation of contingent liabilities, endorsements, compensating balance agreements, lines of credit, and other financial instruments and transactions. The standard form and illustrative letters are reproduced in the AICPA *Audit and Accounting Manual*.) A word of caution is in order: While financial institutions may note exceptions to the information typed in a confirmation and may confirm items omitted from it, the AICPA warns auditors that sole reliance on the form to satisfy the completeness assertion, insofar as cash and loan balances are concerned, is unwarranted. Officers and employees of financial institutions cannot be expected to search their information systems for balances and loans that may not be immediately evident as assets and liabilities of the client company. However, it is a good idea to send confirmations on accounts the company represents as closed during the year to get the bank to confirm zero balances. (If a nonzero balance is confirmed by a bank, the auditors have evidence that some asset accounting is omitted in the company records.)

EXHIBIT 1-2 Bank Confirmation

STANDARD FORM TO CONFIRM ACCOUNT BALANCE INFORMATION WITH FINANCIAL INSTITUTIONS

FINANCIAL INSTITUTIONS' NAME AND ADDRESS

Kingston Company
CUSTOMER NAME

First National Bank
Main Street
Chicago, Illinois

We have provided to our accountants the following information as of the close at business on December 31, 20x1 regarding our deposit and loan balances. Please confirm the accuracy of the information, noting any exceptions to the information provided. If the balances have been left blank, please complete this form by furnishing the balance in the appropriate space below. Although we do not request nor expect you to conduct a comprehensive detailed search of your records, if during the process of completing this confirmation additional information about other deposit and loan accounts we may have with you comes to your attention, please include such information below. Please use the enclosed envelope to return the form directly to our accountants.

1. At the close of business on the date listed above, our records indicated the following deposit balances (s):

Account Name	Account No.	Interest Rate	Balance *
Kingston Company	146-2013	None	$506,100

2. We were directly liable to the financial institution for loans at the close of business on the date listed above as follows:

Account No. / Description	Balance *	Date Due	Interest Rate	Date through which interest is paid	Description of Collateral
042743	$750,000	6/30/20xx	11%	n/a	Unsecured

Larry Lancaster
Customer's Authorized Signature

December 29, 20x1
Dated

The information presented above by the customer is in agreement with our records. Although we have not conducted a comprehensive, detailed search of our records, no other deposit or loan accounts have come to our attention except as noted below.

Bank Representative
Financial Institution Authorized Signature

January 15, 20x2
Dated

Assistance VP
Title

EXCEPTIONS AND/OR COMMENTS

Please return this form directly to our accountants:

Anderson, Olds, Watershed
123 Rush Street
Chicago, Illinois 12345

* Ordinarily balances are intentionally left blank if they are not available at the time the form is prepared.

Approved 1990 by American Bankers Association, American Institute of Certified Public Accountants, and Bank Administration Institute.

CONFIRMATION OF ACCOUNTS AND NOTES RECEIVABLE

Confirmations provide evidence of existence and, to a limited extent, of valuation of accounts and notes receivable. The accounts and notes to be confirmed should be documented in the working papers with an aged trial balance. Accounts for confirmation can be selected at random or in accordance with another plan consistent with the audit objectives. Statistical methods may be useful for determining the sample size. Generalized audit software to access computerized receivables files may be utilized to select and even to print the confirmations.

Two widely used confirmation forms are *positive confirmations* and *negative confirmations*. An example of a positive confirmation is shown in Exhibit 1-3. A variation of the positive confirmation is the *blank form*. A blank confirmation does not contain the balance; customers are asked to fill it in themselves. The blank positive confirmation may produce better evidence because the recipients need to get the information directly from their own records instead of just signing the form and returning it with no exceptions noted. (However, the effort involved may cause a lower response rate.)

The negative confirmation form for the same request shown in Exhibit 1-3 is in Exhibit 1-4. The positive form asks for a response. The negative form asks for a response *only if something is wrong with the balance*; thus, lack of response to negative confirmations is considered evidence of propriety.

The positive form is used when individual balances are relatively large or when accounts are in dispute. Positive confirmations may ask for information about either the account balance or specific invoices, depending on knowledge about how customers maintain their accounting records. The negative form is used mostly when inherent risk and control risk are considered low, when a large number of small balances is involved, and when the client's customers can be expected to consider the confirmations properly. Frequently, both forms are used by sending positive confirmations on some customers' accounts and negative confirmations on others.

Getting confirmations delivered to the intended recipient is a problem that requires auditors' careful attention. Auditors need to control the confirmations, including the addresses to which they are sent. Experience is full of cases where confirmations were mailed to company accomplices, who provided false responses. The auditors should carefully consider features of the reply, such as postmarks, fax and telegraph responses, letterhead, electronic mail, telephone, or other characteristics that may give clues to indicate false responses. Auditors should follow up electronic and telephone responses to determine their origin (e.g., returning the telephone call to a known number, looking up telephone numbers to determine addresses, or using a criss-cross directory to determine the location of a respondent). Furthermore, the lack of response to a negative confirmation is no guarantee that the intended recipient received it unless the auditor carefully controlled the mailing.

EXHIBIT 1-3 Positive Confirmation Letter

Kingston Company
Chicago, Illinois

January 5, 20x2

Charley Company
Lake and Adams
Chicago, Illinois

Gentlemen:

Our auditors, Anderson, Olds, and Watershed, are making their regular audit of our financial statements. Part of this audit includes direct verification of customer balances.

Please examine the date below carefully and either confirm its accuracy or report any differences directly to our auditors using the enclosed reply envelope.

This is not a request for payment. Please do not send your remittance to our auditors.

Your prompt attention to this confirmation request will be appreciated.

Samuel Carboy
Samuel Carboy, Controller

The balance due Kingston Company as of December 31, 20x1 is $1,906. This balance is correct except as noted below:

It's correct. We will send payment as soon as possible. Thank you.

Date: *Jan. 07, 20x2* By: *P. "Charley" O'Quirk*
Title: *President*

EXHIBIT 1-4 Negative Confirmation Letter

Kingston Company
Chicago, Illinois

January 5, 20x2

Charley Company
Lake and Adams
Chicago, Illinois

Gentlemen:

Our auditors, Anderson, Olds, and Watershed, are making their regular audit of our financial statements. Part of this audit includes direct verification of customer balances.

PLEASE EXAMINE THE DATE BELOW CAREFULLY AND COMPARE IT TO YOUR RECORDS OF YOUR ACCOUNT WITH US. <u>IF OUR INFORMATION IS NOT IN AGREEMENT WITH YOUR RECORDS, PLEASE STATE ANY DIFFERENCES ON THE REVERSE SIDE OF THIS PAGE, AND RETURN THIS FORM DIRECTLY TO OUR AUDITORS IN THE RETURN ENVELOPE PROVIDED.</u>

IF THE INFORMATION IS CORRECT, NO REPLY IS NECESSARY.

This is not a request for payment. Please do not send your remittance to our auditors.

Your prompt attention to this confirmation request will be appreciated.

Samuel Carboy

Samuel Carboy, Controller

As of December 31, 20x1, balance due to Kingston Company: $1,906

Date of Origination: November and December, 20x1

Type: Open trade account

The **response rate** for positive confirmations is the proportion of the number of confirmations returned to the number sent, generally after the audit team prompts recipients with second and third requests. Research studies have shown response rates ranging from 66 to 96 percent. Recipients seem to be able to detect account misstatements to varying degrees. Studies have shown **detection rates** (the ratio of the number of exceptions reported to auditors to the number of account errors intentionally reported to customers) ranging from 20 to 100 percent. Negative confirmations seem to have lower detection rates than positive confirmations. Also, studies show somewhat lower detection rates for misstatements favorable to recipients (i.e., an accounts receivable understatement). Overall, positive confirmations appear to be more effective than negative confirmations; but results depend on the type of recipients, the size of the account, and the type of account being confirmed. Effective confirmation practices depend on attention to these factors and on prior years' experience with confirmation results on a particular client's accounts.

Effective confirmation also depends on using a "bag of tricks" to boost the response rate. Often, auditors merely send out a cold, official-looking request in a metered mail envelope and expect customers to be happy to respond. However, the response rate can be increased by using: (1) a postcard sent in advance, notifying that a confirmation is coming; (2) special delivery mail; (3) first-class stamp postage (not metered); and (4) an envelope imprinted "Confirmation Enclosed: Please Examine Carefully." These devices increase the cost of the confirmation procedure, but the benefit is a better response rate.

The audit team should try to obtain replies to all positive confirmations by sending second and third requests to nonrespondents. If there is no response or if the response specifies an exception to the client's records, the auditors should carry out document vouching procedures to audit the account. These alternative procedures include the *vouching direction* of finding sales invoice copies, shipping documents, and customer orders that signal the existence of sales charges. They also are used to find evidence of customers' payments in subsequent cash receipts.

When sampling is used, all accounts in the sample should be audited. It is improper to substitute an easy-to-audit customer account not in the sample for one that does not respond to a confirmation request.

Confirmation of receivables may be performed at a date other than the year-end. When confirmation is done at an interim date, the audit firm is able to spread work throughout the year and avoid the pressures of overtime that typically occur around December 31. Also, the audit can be completed sooner after the year-end date if confirmation has been done earlier. The primary consideration when planning confirmation of accounts before the balance sheet date is the client's internal control over transactions affecting receivables. When confirmation is performed at an interim date, the following additional procedures should be considered:

1. Obtain a summary of receivables transactions from the interim date to the year-end date.
2. Obtain a year-end trial balance of receivables, compare it to the interim trial balance, and obtain evidence and explanations for large variations.
3. Consider the necessity for additional confirmations as of the balance sheet date if balances have increased materially.

One final note about confirmations: Confirmations of accounts, loans, and notes receivable may not produce sufficient evidence of ownership by the client. Debtors may not be aware that the auditor's client has sold their accounts, notes, or loans receivable to financial institutions or to the public (collateralized securities). Auditors need to perform additional inquiry and detail procedures to get evidence of the ownership of the receivables and the appropriateness of disclosures related to financing transactions secured by receivables.

SUMMARY: CONFIRMATIONS

Confirmations of cash balances, loans, accounts receivable, and notes receivable are required, unless auditors can justify substituting other procedures in the circumstances of a particular audit. The bank confirmation is a standard positive form. Confirmations for accounts and notes receivable can be in positive or negative form, and the positive form may be a blank confirmation.

Auditors must take care to control confirmations to ensure that responses are received from the real debtors and not from persons who can intercept the confirmations to give false responses. Responses by fax, telegraph, electronic mail, telephone, or other means not written and signed by a recipient should be followed up to determine their genuine origins. Second and third requests should be sent to prompt responses to positive confirmations, and auditors should audit nonresponding customers by alternative procedures. Accounts in a sample should not be left unaudited (e.g., "They didn't respond"), and easy-to-audit accounts should not be substituted for hard-to-audit ones in a sample. Various "tricks" can be used to raise the response rate.

Confirmations yield evidence about existence and gross valuation. However, the fact that a debtor admits to owing the debt does not mean the debtor can pay. Other procedures must be undertaken to audit the collectibility of the accounts. Nevertheless, confirmations can give some clues about collectibility when customers tell about balances in dispute. Confirmations of accounts, notes, and loans receivable should not be used as the only evidence of the ownership of these financial assets.

SPECIAL NOTE: AUDIT OF BANK RECONCILIATIONS WITH ATTENTION TO LAPPING AND KITING

The company's bank reconciliation is the primary means of valuing cash in the financial statements. The amount of cash in the bank is almost always different from the amount in the general ledger (financial statements), and the reconciliation purports to explain the difference. The normal procedure is to obtain the company-prepared bank reconciliation and audit it. Auditors should not perform the company's control function of preparing the reconciliation.

A client-prepared bank reconciliation is shown in Exhibit 1-5. The bank balance is confirmed and cross-referenced to the bank confirmation working paper (Exhibit 1-2). The reconciliation is recalculated, the outstanding checks and deposits in transit are footed, and the book balance is traced to the trial balance (which has been traced to the general ledger). The reconciling items should be vouched to determine whether outstanding checks really were not paid and that deposits in transit actually were mailed before the reconciliation date. The auditors' information source for vouching the bank reconciliation items is a **cutoff bank statement**, which is a complete bank statement including all paid checks and deposit slips. The client requests the bank to send this bank statement directly to the auditor. It is usually for a 10- to 20-day period following the reconciliation date. (It also can be the next regular monthly statement, received directly by the auditors.)

The vouching of outstanding checks and deposits in transit is a matter of comparing checks that cleared in the cutoff bank statement with the list of outstanding checks for evidence that all checks that were written prior to the reconciliation date were on the list of outstanding checks. The deposits shown in transit should be recorded by the bank in the first business days of the cutoff period. If recorded later, the inference is that the deposit may have been made up from receipts of the period after the reconciliation date. For large outstanding checks not clearing in the cutoff period, vouching may be extended to other documentation supporting the disbursement. These procedures are keyed and described by tickmarks in Exhibit 1-5.

ACCOUNTS RECEIVABLE LAPPING

When the business receives many payments from customers, a detailed audit should include comparison of the checks listed on a sample of deposit slips (from the reconciliation month and other months) to the detail of customer credits listed on the day's posting to customer accounts receivable (daily remittance list or other record of detail postings). This procedure is a test for accounts receivable lapping. It is an attempt to find credits given to customers for whom no payments were received on the day in question. An example of this type of comparison is in the discovery summary section of Case 1.1 (The Canny Cashier) later in this chapter.

EXHIBIT 1-5 Bank Reconciliation

Kingston Company
Bank Reconciliation -- First National Bank
General Account
12/31/20x1
(Prepared by client)

Prepared *J.D. 1/10/20x2* Reviewed: *R.A 1/10/20x2*

Balance per bank statement 506,100 *a*

Add:

Deposit in transit as of 12/31/20x1 51,240 *n*

557,340

Deduct outstanding checks:

Date	No.	Payee	Amount	
12/10/20x0	842	Ace Supply Company	500	×
11/31/20x1	1280	Ace Supply Company	1,800	√
12/15/20x1	1372	Norwest Lumber Co	30,760	√
12/28/20x1	1412	Gibson & Johnson	7,270	☑
12/30/20x1	1417	First National Payroll	20,000	√
12/30/20x1	1418	Ace Supply Company	2,820	√
12/30/20x1	1419	Windy City Utilities	2,030	√
12/30/20x1	1420	Howard Hardware	8,160	√

73,340

Balance per book 484,000 *f*
=======

Note: Obtained cutoff bank statement 1/9/20x2

f Footed
a Confirmed by bank, standard bank confirmation
n Vouched to cutoff bank statement, deposit recorded by bank on 1/3/20x2. Vouched to duplicate deposit slip validated 1/3/20x2.
√ Vouched to paid check cleared with cutoff bank statement
☑ Vouched to statement from attorneys
× Amount in dispute per controller

CHECK KITING

The possibility of check kiting has been substantially reduced due to "Check 21." "Check 21" requires banks to clear checks in minimal time, thus reducing float. Less float = less check kiting – not eliminated, but severely reduced. We believe it is still relevant for the CPA to understand what check kiting is and how to detect it.

Auditors also should be alert to the possibility of a company's practice of illegal "kiting." **Check kiting** is the practice of building up balances in one or more bank accounts based on uncollected (float) checks drawn against similar accounts in other banks. Kiting involves depositing money from one bank account to another, using a hot check. The depository bank does not know the check is on insufficient funds, but the deficiency is covered by another hot check from another bank account before the first check clears. Kiting is the deliberate floating of funds between two or more bank accounts. By this method, a bank customer uses the time required for checks to clear to obtain an unauthorized loan without any interest charge.

Professional money managers working for cash-conscious businesses try to have minimal unused balances in their accounts, and their efforts sometimes can look like check kites. Tight cash flows initiate kites, and *intent to kite* is the key for criminal charges. Kites evolve to include numerous banks and numerous checks. The more banks and broader geographical distance, the harder a perpetrator finds it to control a kite scheme.

The transactions described below illustrate a simple kite scheme. The transactions are shown in Exhibit 1-6.

Start with no money in the First National Bank and none in the Last National Bank. Run the kite quickly from July 3 (Monday) through July 12 (next Wednesday) – taking advantage of the holiday and the weekend to float the hot checks.

A. Deposit a $15,000 check drawn on First National Bank to the Last National account. Simultaneously, deposit a $10,000 check drawn on Last National Bank to the First National account. Do not record the deposits and disbursements in the general ledger.
B. Deposit an $11,000 check drawn on First National Bank to the Last National account. Simultaneously, deposit a $13,000 check drawn on Last National Bank to the First National account. Do not record the deposits and disbursements in the general ledger.
C. Purchase an $8,000 certified check from First National Bank to make a down payment on a Mercedes automobile. Record the check in the general ledger.
D. The first transfer checks (part **A**) clear each bank.
E. Deposit a $16,000 check drawn on First National Bank to the Last National account. Simultaneously, deposit a $14,000 check drawn on Last National Bank to the First National account. Do not record the deposits and disbursements in the general ledger.
F. Write checks for $14,000 drawn on First National Bank and $32,000 drawn on Last National Bank payable to a travel agent, and take a long trip (preferably to a country with no extradition treaty!).

G. When the checks are presented to the banks for payment, the accounts are empty. A total of $79,000 was kited, of which $25,000 cleared during the kite period (the first transfers in **A**), so the "take" was $54,000. The criminals got the Mercedes ($8,000) and the vacation funds ($46,000).

EXHIBIT 1-6 Illustrative Check Kiting Transactions

			First National Bank		Last National Bank	
Index	Date	Transaction	At Bank (1)	Actual (2)	At Bank (1)	Actual (2)
A	July 3	1st transfer	-----	($15,000)	$15,000	$15,000
A	July 3	1st transfer	$10,000	$10,000	-----	($10,000)
		Balances	$10,000	($5,000)	$15,000	$5,000
B	July 5	2nd transfer	-----	($11,000)	$11,000	$11,000
B	July 5	2nd transfer	$13,000	$13,000	-----	($13,000)
		Balances	$23,000	($3,000)	$26,000	$3,000
C	July 6	Mercedes	($8,000)	($8,000)		
		Balances	$15,000	($11,000)	$26,000	$3,000
D	July 7	1st trnsfr clear	($15,000)		($10,000)	
E	July 7	3rd transfer	-----	($16,000)	$16,000	$16,000
E	July 7	3rd transfer	$14,000	$14,000	-----	($14,000)
		Balances	$14,000	($13,000)	$32,000	$5,000
F	July 8	Pay travel	-----	($14,000)	-----	($32,000)
		Balances	$14,000	($27,000)	$32,000	($27,000)
G	July 10	2nd trnsfr clear	($11,000)		($13,000)	
G	July 12	3rd trnsfr clear	($16,000)		($14,000)	
G	July 12	Travel clear	($14,000)		($32,000)	
			($27,000)		($27,000)	

(1) "At Bank" means the bank's records of deposits received and checks paid (cleared).
(2) "Actual" means the amounts the general ledger would have shown had the transfers been recorded.

These are some characteristic signs of check kiting schemes:

- Frequent deposits and checks in same amounts.
- Frequent deposits and checks in round amounts.
- Frequent deposits with checks written on the same (other) banks.
- Short time lag between deposits and withdrawals.
- Frequent ATM account balance inquiries.
- Many large deposits made on Thursday or Friday to take advantage of the weekend.
- Large periodic balances in individual accounts with no apparent business explanation.
- Low average balance compared to high level of deposits.
- Many checks made payable to other banks.
- Bank willingness to pay against uncollected funds.
- "Cash" withdrawals with deposit checks drawn on another bank.
- Checks drawn on foreign banks with lax banking laws and regulations.

Auditors can detect the above signs of check kiting by reviewing bank account activity. The only trouble is that criminal check kiters often destroy the banking documents. If a company cannot or will not produce its bank statements, with all deposit slips and canceled checks, the auditors should be wary.

If these cash transfers are recorded in the books, a company will show the negative balances that result from checks drawn on insufficient funds. However, perpetrators may try to hide the kiting by not recording the deposits and checks. Such maneuvers may be detectable in a bank reconciliation audit.

SUMMARY: BANK RECONCILIATIONS, LAPPING AND KITING

The combination of all the procedures performed on the bank reconciliation provides evidence of existence, valuation, and proper cutoff of the bank cash balances. Auditors use a cutoff bank statement to obtain independent evidence of the proper listing of outstanding checks and deposits in transit on a bank reconciliation.

Additional procedures can be performed to try to detect attempts at lapping accounts receivable collections and kiting checks. For lapping, these procedures include auditing the details of customer payments listed in bank deposits in comparison to details of customer payment postings (remittance lists). For kiting, these procedures include being alert to the signs of kites and preparing a schedule of interbank transfers and a proof of cash.

BANK TRANSFER SCHEDULE AND "PROOF OF CASH"

Auditors usually prepare a schedule of interbank transfers to determine whether transfers of cash from one bank to another were recorded properly (correct amount and correct date). Assume the facts given in the preceding kiting illustration, and the following: (1) the First National Bank account is the company's general bank account, and the Last National Bank account is the payroll account, (2) the company pays its payroll on the 15th and 30th days of each month, and (3) the company transfers the net amount of each payroll from the general account to the payroll account. A "schedule of interbank transfers" prepared from the recorded entries in the general ledger would look like the one in Panel A in Exhibit 1-7.

However, we know that the managers performed a check kite and did not record several transfers between these accounts. Auditors should review the bank statements, and find the other transfers, and put them on the schedule (shown in Panel B in Exhibit 1-7). Panel B shows how the auditors can document the unrecorded transfers.

EXHIBIT 1-7 Illustration of Interbank Transfer Schedule

	Disbursing Account				Receiving Account		
Check No.	Bank	Amount	Date per Books	Date per Bank	Bank	Date per Books	Date per Bank
PANEL A							
7602	1st Nat'l	$24,331	July 14	July 18	Last Nat'l	July 14	July 14
8411	1st Nat'l	$36,462	July 28	Aug 1	Last Nat'l	July 28	July 28
PANEL B							
6722	1st Nat'l	$15,000	None	July 7	Last Nat'l	None	July 3
11062	Last Nat'l	$10,000	None	July 7	1st Nat'l	None	July 3
6793	1st Nat'l	$11,000	None	July 10	Last Nat'l	None	July 5
11097	Last Nat'l	$13,000	None	July 10	1st Nat'l	None	July 5
6853	1st Nat'l	$16,000	None	July 12	Last Nat'l	None	July 7
11106	Last Nat'l	$14,000	None	July 12	1st Nat'l	None	July 7

Auditors can use another method to discover unrecorded cash transactions. It is called a "proof of cash." You may know this method under the name of "four-column bank reconciliation." The proof of cash is a reconciliation in which the bank balance, the bank report of cash deposited, and the bank report of cash paid are all reconciled to the company's general ledger. Exhibit 1-8 illustrates a proof of cash. The illustration assumes some bank reconciliation information, some transaction activity, and the unrecorded transfers for the First National Bank account used in the previous illustrations of kiting and interbank transfers. (Changing the kiting illustration: the bank accounts did not start with zero balances.)

The proof of cash attempt to reconcile the deposits and payments reported by the bank to the deposits and payments recorded in the general ledger will reveal the unrecorded transfers. The amounts will not reconcile until the auditors inspect the bank statement and find the bank amounts that are not in the general ledger. (Likewise, the attempt to reconcile the July 31 bank balance will show a $5,000 difference, which is explained by the $37,000 unrecorded deposits and the $42,000 unrecorded payments.)

EXHIBIT 1-8 Illustration of Proof of Cash – First National Bank

	Balance June 30	Deposits	Payments	Balance July 31
Bank statement amounts	$264,322	$398,406	$390,442	$272,286
Deposits in transit				
June 30	76,501	(76,501)		
July 31		79,721		79,721
Outstanding checks				
June 30	(89,734)		(89,734)	
July 31			62,958	(62,958)
Unrecorded bank interest (recorded in next month)				
June 30	(162)	162		
July 31		(155)		(155)
Unrecorded service charges (recorded in the next month)				
June 30	118		118	
July 31			(129)	129
Unrecorded transfers received from Last National Bank		(37,000)		(37,000)
Unrecorded transfers to Last National Bank			(42,000)	42,000
General ledger amounts	$251,045	$364,633	$321,655	$294,023
	=======	=======	=======	=======

AUDIT CASES: SUBSTANTIVE AUDIT PROCEDURES

The audit procedures to gather evidence on account balances are called "substantive procedures.'' Some amount of substantive audit procedures must be performed in all audits. Auditors should not place total reliance on controls to the exclusion of other procedures. Substantive audit procedures differ from test of controls audit procedures in their basic purpose. Substantive procedures are designed to obtain direct evidence about the dollar amounts in account balances, while test of controls procedures are designed to obtain evidence about the company's performance of its own control activities. Sometimes an audit procedure can be used for both purposes simultaneously, and then it is called a **dual-purpose procedure**.

DUAL-PURPOSE NATURE OF ACCOUNTS
RECEIVABLE CONFIRMATIONS

Accounts receivable confirmation is a substantive procedure designed to obtain evidence of the existence and gross amount (valuation) of customers' balances directly from the customer. If such confirmations show numerous exceptions, auditors would be concerned with the controls over the details of sales and cash receipts transactions even if previous control evaluations seemed to show little control risk.

The goal in performing substantive procedures is to detect evidence of errors and frauds, if any exist in the accounts as material overstatements or understatements of account balances. In the remainder of this part of the chapter, the approach is to use a set of cases which contain specific examples of test of controls and substantive audit procedures (recalculation, observation, confirmation, inquiry, vouching, tracing, scanning, and analysis). The case stories are used instead of listing schemes and detection procedures in the abstract.

The cases follow a standard format, which first tells about an error or fraud situation. This part is followed by an "audit approach'' section that tells about the audit objective (assertion), controls, test of controls, and audit of balances (substantive procedures) that could be considered in an approach to the situation. The audit approach section presumes that the auditors do not know everything about the situation. (As a student of the case, you have "inside information.'')

These are the parts of the case situation description for each one:

Method: A cause of the misstatement (accidental error or fraud attempt), which usually is made easier by some kind of failure of controls.

Paper trail: A set of telltale signs of erroneous accounting, missing or altered documents, or a "dangling debit'' (the false or erroneous debit that results from an overstatement of assets).

Amount: The dollar amount of overstated assets and revenue, or understated liabilities and expenses.

The audit approach section contains these parts:

Audit objective: A recognition of a financial statement *assertion* for which evidence needs to be obtained. The assertions are about existence of assets, liabilities, revenues, and expenses; their valuation; their complete inclusion in the account balances; the rights and obligations inherent in them; and their proper presentation and disclosure in the financial statements.

Control: A recognition of the control activities that *should* be used in an organization to prevent and detect errors and frauds.

Test of controls: Ordinary and extended procedures *designed to produce evidence about the effectiveness of the controls* that should be in operation.

Audit of balances: Ordinary and extended *substantive procedures designed to find signs* of errors and frauds in account balances and classes of transactions.

CASE 1.1 : THE CANNY CASHIER

Problem

Cash embezzlement caused overstated accounts receivable, overstated customer discounts expense, and understated cash sales. Company failed to earn interest income on funds "borrowed."

Method

D. Bakel was the assistant controller of Sports Equipment, Inc. (SEI), an equipment retailer. SEI maintained accounts receivable for school districts in the region, otherwise customers received credit by using their own credit cards.

Bakel's duties included being the company cashier, who received all the incoming mail payments on school accounts and the credit card account and all the cash and checks taken over the counter. Bakel prepared the bank deposit (and delivered the deposit to the bank), listing all the checks and currency, and also prepared a remittance worksheet (daily cash report) that showed amounts received, discounts allowed on school accounts, and amounts to credit to the accounts receivable. The remittance worksheet was used by another accountant to post credits to the accounts receivable. Bakel also reconciled the bank statement. No one else reviewed the deposits or the bank statements except the independent auditors.

Bakel opened a bank account in the name of Sport Equipment Company (SEC), after properly incorporating the company in the secretary of state's office. Over-the-counter cash and checks and school district payments were taken from the SEI receipts and deposited in the SEC account. (None of the customers noticed the difference between the rubber stamp endorsements for the two similarly named corporations, and neither did the bank.) SEC kept the money awhile, earning interest, then Bakel wrote SEC checks to SEI to replace the "borrowed" funds, in the meantime taking new SEI receipts for deposit to SEC. Bakel also stole payments made by the school districts, depositing them to SEC. Later, Bakel deposited SEC checks in SEI, giving the schools credit, but approved an additional 2 percent discount in the process. Thus, the schools received proper credit later, and SEC paid in less by the amount of the extra discounts.

Paper Trail

SEI's bank deposits systematically showed fairly small currency deposits. Bakel was nervous about taking too many checks, so cash was preferred. The deposit slips also listed the SEC checks because bank tellers always compare the deposit slip listing to the checks submitted. The remittance worksheet showed different details: Instead of showing SEC checks, it showed receipts from school districts and currency, but not many over-the-counter checks from customers.

The transactions became complicated enough that Bakel had to use the microcomputer in the office to keep track of the school districts that needed to get credit. There were no vacations for this hard-working cashier because the discrepancies might be noticed by a substitute, and Bakel needed to give the districts credit later.

Amount

Over a six-year period, Bakel built up a $150,000 average balance in the Sport Equipment Company (SEC) account, which earned a total of $67,500 interest that should have been earned by Sports Equipment, Inc. (SEI). By approving the "extra" discounts, Bakel skimmed 2 percent of $1 million in annual sales, for a total of $120,000. Since SEI would have had net income before taxes of about $1.6 million over this six years (about 9 percent on the sales dollar), Bakel's embezzlement took about 12.5 percent of the income.

AUDIT APPROACH

Objective
Obtain evidence to determine whether the accounts receivable recorded on the books represent claims against real customers in the gross amounts recorded.

Control
Authorization related to cash receipts, custody of cash, recording cash transactions, and bank statement reconciliation should be separate duties designed to *prevent* errors and frauds. Some supervision and detail review of one or more of these duties should be performed as a next-level control designed to *detect* errors and frauds, if they have occurred. For example, the remittance worksheet should be prepared by someone else, or at least the discounts should be approved by the controller; the bank reconciliation should be prepared by someone else other than Bakel.

Bakel had all the duties. (While recording was not actually performed, Bakel provided the source document – the remittance worksheet – the other accountant used to make the cash and accounts receivable entries.) According to the company president, the "control" was the diligence of "our" long-time, trusted, hard-working assistant controller. *Note*: An auditor who "thinks like a crook" to imagine ways Bakel could commit errors or fraud could think of this scheme for cash embezzlement and accounts receivable lapping.

Test of Controls
Since the "control" purports to be Bakel's honest and diligent performance of the accounting and control activities that might have been performed by two or more people, the test of controls is an audit of cash receipts transactions as they relate to accounts receivable credit. The dual-direction samples and procedures are these:

Validity direction: Select a sample of customer accounts receivable, and vouch payment credits to remittance worksheets and bank deposits, including recalculation of discounts allowed in comparison to sales terms (2 percent), classification (customer name) identification, and correspondence of receipt date to recording date.

Completeness direction: Select a sample of remittance worksheets (or bank deposits), vouch details to bank deposit slips (trace details to remittance worksheets if the sample is bank deposits), and trace forward to complete accounting posting in customer accounts receivable.

Audit of Balance
Since there is a control risk of incorrect accounting, perform the accounts receivable confirmation as of the year-end date. Confirm a sample of school district accounts, using positive confirmations. Blank confirmations may be used. Since there is a control risk, the "sample" may be all the accounts, if the number is not too large.

As prompted by notice of an oddity (noted in the discovery summary below), use the telephone book, chamber of commerce directory, local criss-cross directory, and a visit to the secretary of state's office to determine the location and identity of Sport Equipment Company.

Discovery Summary

The test of controls samples showed four cases of discrepancy, one of which is shown below.

The auditors sent positive confirmations on all 72 school district accounts. Three of the responses stated the districts had paid the balances before the confirmation date. Follow-up procedures on their accounts receivable credit in the next period showed they had received credit in remittance reports, and the bank deposits had shown no checks from the districts but had contained a check from Sports Equipment Company. Investigation of SEC revealed the connection of Bakel, who was confronted and then confessed.

Bank Deposit Slip

Jones	25
Smith	35
Hill District	980
Sport Equipment	1,563
Currency	540
Deposit	3,143

Cash Remittance Report

Name	Amount	Discount	AR	Sales
Jones	25	0	0	25
Smith	35	0	0	35
Hill Dist.	980	20	1,000	0
Marlin Dist.	480	20	500	0
Waco Dist.	768	32	800	0
Currency	855	0	0	855
Totals	3,143	72	2,300	915

CASE 1.2: THE TAXMAN ALWAYS RINGS TWICE

Problem

Overstated receivables for property taxes in a school district because the tax assessor stole some taxpayers' payments.

Method

J. Shelstad was the tax assessor-collector in the Ridge School District, serving a large metropolitan area. The staff processed tax notices on a computer system and generated 450,000 tax notices each October. An office copy was printed and used to check off "paid" when payments were received. Payments were processed by computer, and a master file of "accounts receivable" records (tax assessments, payments) was kept on the computer hard disk.

Shelstad was a good personnel manager, who often took over the front desk at lunchtime so the teller staff could enjoy lunch together. During these times, Shelstad took payments over the counter, gave the taxpayers a counter receipt, and pocketed some of the money, which was never entered in the computer system.

Shelstad resigned when he was elected to the Ridge school board. The district's assessor-collector office was eliminated upon the creation of a new countywide tax agency.

Paper Trail

The computer records showed balances due from many taxpayers who had actually paid their taxes. The book of printed notices was not marked "paid" for many taxpayers who had received counter receipts. These records and the daily cash receipts reports (cash receipts journal) were available at the time the independent auditors performed the most recent annual audit in April. When Shelstad resigned in August, a power surge permanently destroyed the hard disk receivables file, and the cash receipts journals could not be found.

The new county agency managers noticed that the total of delinquent taxes disclosed in the audited financial statements was much larger than the total turned over to the country attorney for collection and foreclosure.

Amount

Shelstad had been the assessor-collector for 15 years. The "good personnel manager" pocketed 100-150 counter payments each year, in amounts of $500-$2,500, stealing about $200,000 a year for a total of approximately $2.5 million. The district had assessed about $800-$900 million per year, so the annual theft was less than 1 percent. Nevertheless, the taxpayers got mad.

AUDIT APPROACH

Objective

Obtain evidence to determine whether the receivables for taxes (delinquent taxes) represent genuine claims collectible from the taxpayers.

Control

The school district had a respectable system for establishing the initial amounts of taxes receivable. The professional staff of appraisers and the independent appraisal review board established the tax base for each property. The school board set the price (tax rate). The computer system authorization for billing was validated on these two inputs.

The cash receipts system was well designed, calling for preparation of a daily cash receipts report (cash receipts journal that served as a source input for computer entry). This report was always reviewed by the "boss,'' Shelstad.

Unfortunately, Shelstad had the opportunity and power to override the controls and become both cash handler and supervisor. Shelstad made the decisions about sending delinquent taxes to the county attorney for collection, and the ones known to have been paid but stolen were withheld.

Test of Controls

The auditors performed dual-direction sampling to test the processing of cash receipts.

Validity direction: Select a sample of receivables from the computer hard disk, and vouch (1) charges to the appraisal record, recalculating the amount using the authorized tax rate and (2) payments, if any, to the cash receipts journal and bank deposits. (The auditors found no exceptions.) *Completeness direction*: Select a sample of properties from the appraisal rolls, and determine that tax notices had been sent and tax receivables (charges) recorded in the computer file. Select a sample of cash receipts reports, vouch them to bank deposits of the same amount and date, and trace the payments forward to credits to taxpayers' accounts.

Select a sample of bank deposits, and trace them to cash receipts reports of the same amount and date. In one of these latter two samples, compare the details on bank deposits to the details on the cash receipts reports to determine whether the same taxpayers appear on both documents. (The auditors found no exceptions.)

Audit of Balance

Confirm a sample of unpaid tax balances with taxpayers. Response rates may not be high, and follow-up procedures determining the ownership (county title files) may need to be performed, and new confirmations may need to be sent.

Determine that proper disclosure is made of the total of delinquent taxes and the total of delinquencies turned over to the county attorney for collection proceedings.

Discovery Summary

Shelstad persuaded the auditors that the true "receivables" were the delinquencies turned over to the county attorney. The confirmation sample and other work was based on this population. Thus, confirmations were not sent to fictitious balances that Shelstad knew had been paid, and the auditors never had the opportunity to receive "I paid" complaints from taxpayers.

The new managers of the countywide tax district were not influenced by Shelstad. They questioned the discrepancy between the delinquent taxes in the audit report and the lower amount turned over for collection. Since the computer file was not usable, the managers had to use the printed book of tax notices, where paid accounts had been marked "paid." (Shelstad had not marked the stolen ones "paid" so the printed book would agree with the computer file.) Tax due notices were sent to the taxpayers with unpaid balances, and they began to show up bringing their counter receipts and loud complaints.

In a fit of audit overkill, the independent auditors had earlier photocopied the entire set of cash receipts reports (cash journal), and they were then able to determine that the counter receipts (all signed by Shelstad) had not been deposited or entered. Shelstad was prosecuted and sentenced to a jail term.

CASE 1.3 : BILL OFTEN, BILL EARLY

Problem

Overstated sales and receivables, understated discounts expense, and overstated net income resulted from recording sales too early and failure to account for customer discounts taken.

Method

McGossage Company experienced profit pressures for two years in a row. Actual profits were squeezed in a recessionary economy, but the company reported net income decreases that were not as severe as other companies in the industry.

Sales were recorded in the grocery products division for orders that had been prepared for shipment but not actually shipped until later. Employees backdated the shipping documents. Gross profit on these "sales" was about 30 percent. Customers took discounts on payments, but the company did not record them, leaving the debit balances in the customers' accounts receivable instead of charging them to discounts and allowances expense. Company accountants were instructed to wait 60 days before recording discounts taken.

The division vice president and general manager knew about these accounting practices, as did a significant number of the 2,500 employees in the division. The division managers were under orders from headquarters to achieve profit objectives they considered unrealistic.

Paper Trail

The customers' accounts receivable balances contained amounts due for discounts the customers already had taken. The cash receipts records showed payments received without credit for discounts. Discounts were entered monthly by a special journal entry.

The unshipped goods were on the shipping dock at year-end with papers showing earlier shipping dates.

Amount

As misstatements go, some of these were on the materiality borderline. Sales were overstated 0.3 percent and 0.5 percent in the prior and current year, respectively. Accounts receivable were overstated 4 percent and 8 percent. But the combined effect was to overstate the division's net income by 6 percent and 17 percent. Selected data were:

	One Year Ago *		Current Year *	
	Reported	Actual	Reported	Actual
Sales	$330.0	$329.0	$350.0	$348.0
Discounts expense	1.7	1.8	1.8	2.0
Net Income	6.7	6.3	5.4	4.6

*Dollars in millions.

AUDIT APPROACH

Objective

Obtain evidence to determine whether sales were recorded in the proper period and whether gross accounts receivable represented the amounts due from customers at year-end.

Obtain evidence to determine whether discounts expense was recognized in the proper amount in the proper period.

Control

The accounting manual should provide instructions to record sales on the date of shipment (or when title passes, if later). Management subverted this control procedure by having shipping employees date the shipping papers incorrectly.

Cash receipts procedures should provide for authorizing and recording discounts when they are taken by customers. Management overrode this control instruction by giving instructions to delay the recording.

Test of Controls

Questionnaires and inquiries should be used to determine the company's accounting policies. It is possible that employees and managers would lie to the auditors to conceal the policies. It is also possible that pointed questions about revenue recognition and discount recording policies would elicit answers to reveal the practices.

For detail procedures: Select a sample of cash receipts, examine them for authorization, recalculate the customer discounts, trace them to accounts receivable input for recording of the proper amount on the proper date. Select a sample of shipping documents and vouch them to customer orders, then trace them to invoices and to recording in the accounts receivable input with proper amounts on the proper date. These tests follow the *tracing direction* – starting with data that represent the beginning of transactions (cash receipts, shipping) and tracing them through the company's accounting process.

Audit of Balance

Confirm a sample of customer accounts. Use analytical relationships of past years' discount expense to a relevant base (sales, sales volume) to calculate an overall test of the discounts expense.

Discovery Summary

The managers lied to the auditors about their revenue and expense timing policies. The sample of shipping documents showed no dating discrepancies because the employees had inserted incorrect dates. The analytical procedures on discounts did not show the misstatement because the historical relationships were too erratic to show a deficient number (outlier). However, the sample of cash receipts transactions showed that discounts were not calculated and recorded at time of receipt. Additional inquiry led to discovery of the special journal entries and knowledge of the recording delay. Two customers in the sample of 65 confirmations responded with exceptions that turned out to be unrecorded discounts.

Two other customers in the confirmation sample complained that they did not owe for late invoices on December 31. Follow-up showed the shipments were goods noticed on the shipping dock. Auditors taking the physical inventory noticed the goods on the shipping dock during the December 31 inventory-taking. Inspection revealed the shipping documents dated December 26. When the auditors traced these shipments to the sales recording, they found them recorded "bill and hold" on December 29. (These procedures were performed and the results obtained by a successor audit firm in the third year!)

CASE 1.4: THANK GOODNESS IT'S FRIDAY

Problem

Overstated sales caused overstated net income, retained earnings, current assets, working capital, and total assets. Overstated cash collections did not change the total current assets or total assets, but it increased the amount of cash and decreased the amount of accounts receivable.

Method

Alpha Brewery Corporation generally has good control policies and procedures related to authorization of transactions for accounting entry, and the accounting manual has instructions for recording sales transactions in the proper accounting period. The company regularly closes the accounting process each Friday at 5 P.M. to prepare weekly management reports. The year-end date (cutoff date is December 31, and, in 20X0, December 31 was a Monday. However, the accounting was performed through Friday as usual, and the accounts were closed for the year on January 4.

Paper Trail

All the entries were properly dated after December 31, including the sales invoices, cash receipts, and shipping documents.

However, the trial balance from which the financial statements were prepared was dated December 31, 20X0. Nobody noticed the slip of a few days because the Friday closing was normal.

Amount

Alpha recorded sales of $672,000 and gross profit of $268,800 over the January 1-4 period. Cash collections on customers' accounts were recorded in the amount of $800,000.

AUDIT APPROACH

Objective

Obtain evidence to determine the existence, completeness, and valuation of sales for the year ended December 31, 20X0, and cash and accounts receivable as of December 31, 20X0.

Control

The company had in place the proper instructions to people to date transactions on the actual date on which they occurred and to enter sales and cost of goods sold on the day of shipment and to enter cash receipts on the day received in the company offices. An accounting supervisor should have checked the entries through Friday to make sure the dates corresponded with the actual events, and that the accounts for the year were closed with Monday's transactions.

Test of Controls

In this case, the auditors need to be aware of the company's weekly routine closing and the possibility that the intervention of the December 31 date might cause a problem. Asking the question: "Did you cut off the accounting on Monday night this week?" might elicit the "Oh, we forgot!" response. Otherwise, it is normal to sample transactions around the year-end date to determine whether they were recorded in the proper accounting period.

The procedure: Select transactions 7-10 days before and after the year-end date, and inspect the dates on supporting documentation for evidence of accounting in the proper period.

Audit of Balance

The audit for sales overstatement is partly accomplished by auditing the cash and accounts receivable at December 31 for overstatement (the dangling debit location). Confirm a sample of accounts receivable. If the accounts are too large, the auditors expect the debtors to say so, thus leading to detection of sales overstatements.

Cash overstatement is audited by auditing the bank reconciliation to see whether deposits in transit (the deposits sent late in December) actually cleared the bank early in January. Obviously, the January 4 cash collections could not reach the bank until at least Monday, January 7. That's too long for a December 31 deposit to be in transit to a local bank.

The completeness of sales recordings is audited by selecting a sample of sales transactions (and supporting shipping documents) in the early part of the next accounting period (January 20X1). One way that sales of 20X0 could be incomplete would be to postpone recording December shipments until January, and this procedure will detect them if the shipping documents are dated properly.

Audit of Balance continued

The completeness of cash collections (and accounts receivable credits) are audited by auditing the cash deposits early in January to see whether there is any sign of holding cash without entry until January.

In this case, the existence objective is more significant for discovery of the problem than the completeness objective. After all, the January 1-4 sales, shipments, and cash collections did not "exist" in December 20X0.

Discovery Summary

The test of controls sample from the days before and after December 31 quickly revealed the problem. Company accounting personnel were embarrassed, but there was no effort to misstate the financial statements. This was a simple error. The company readily made the following adjustment:

	Debit	Credit
Sales	$672,000	
Inventory	$403,200	
Accounts Receivable	$800,000	
Accounts Receivable		$672,000
Cost of goods sold		$403,200
Cash		$800,000

SUMMARY

The revenue and collection cycle consists of customer order processing, credit checking, shipping goods, billing customers and accounting for accounts receivable, and collecting and accounting for cash receipts. Companies reduce control risk by having a suitable separation of authorization, custody, recording, and periodic reconciliation duties. Error-checking activities of comparing customer orders and shipping documents are important for billing customers the right prices for the delivered quantities. Otherwise, many things could go wrong – ranging from making sales to fictitious customers or customers with bad credit to erroneous billings for the wrong quantities at the wrong prices at the wrong time.

Cash collection is a critical point for asset control. Many cases of embezzlement occur in this process. Illustrative cases in the chapter tell the stories of some of these cash embezzlement schemes, including the practice of "lapping" accounts receivable.

Three topics have special technical notes in the chapter. The *existence assertion* is very important in the audit of cash and receivables assets because misleading financial statements often have contained overstated assets and revenue. The *use of confirmations* gets a special section because confirmation is frequently used to obtain evidence of asset existence from outside parties, such as customers who owe on accounts receivable. The *audit of bank reconciliations* is covered in the context of an audit opportunity to recalculate the amount of cash for the financial statements and to look for signs of accounts receivable lapping and check kiting. The *schedule of interbank transfers* and the *proof of cash* methods are tools auditors can use to find unrecorded cash transactions.

CHAPTER 1 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. The basic activities in the revenue and collection cycle include all of the following except:

   a) receiving and processing customer orders, including credit granting
   b) delivering goods and services to customers
   c) reconciling bank statements
   d) obtaining bank loans

2. Which of the following reports should be reviewed for evidence of the completeness of recorded sales and accounts receivable:

   a) pending order master file
   b) credit check files
   c) price list master file
   d) sales detail (sales journal) file

3. Which of the following would not be an acceptable justification for not using confirmations for cash balances and trade accounts receivable:

   a) receivables are not material
   b) confirmations would be ineffective, based on prior years' experience or knowledge that responses could be unreliable
   c) analytical procedures and other substantive tests of details procedures provide sufficient, competent evidence
   d) the preparation of the confirmations is costly

4. Which of the following is true regarding accounts receivable confirmations:

   a) response rates for positive confirmations usually run close to 100%
   b) negative confirmations tend to have lower detection rates than positive confirmations
   c) overall, negative confirmations appear to be more effective than positive confirmations
   d) there is nothing that can be done to increase confirmation response rates

5. Which of the following is a characteristic sign of check kiting:

   a) frequent ATM account balance inquiries
   b) few checks made to other banks
   c) large deposits made on Mondays
   d) long periods between deposits and withdrawals

CHAPTER 1 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. Receiving and processing orders is one of the typical activities.

   B: Incorrect. Delivering goods and services to customers is one of the typical activities.

   C: Incorrect. Reconciling the bank statement is a typical activity in the revenue and collection cycle.

   D: Correct. Obtaining a bank loan is not one of the typical activities included in the revenue and collection cycle. Other basic activities included in this cycle are billing customers and accounting for accounts receivable, and collecting and depositing cash received from customers.

   (See page 1-1 of the course material.)

2. **A: Correct.** This file contains sales transactions that were started in the system but are not yet completed, thus not recorded as sales and accounts receivable. Old orders may represent shipments that actually were made, but for some reason the shipping department did not enter the shipping information (or entered an incorrect code that did not match the pending order file).

   B: Incorrect. Credit check files are used to make automatic credit checks. A sample of the files should be tested for current status, or the company's records on updating the files can be reviewed for evidence of updating operations.

   C: Incorrect. The price list master file is used to produce customer invoices automatically and should be compared to an official price source for accuracy.

   D: Incorrect. This file should contain the detail sales entries, including the shipping reference and dates, and contains the population of debit entries to the accounts receivable.

   (See page 1-6 of the course material.)

3. A: Incorrect. This is a reasonable justification, but should be documented for a particular audit.

   B: Incorrect. This is a reasonable justification, but should be documented for a particular audit.

   C: Incorrect. This is a reasonable justification, but should be documented for a particular audit.

   D: Correct. Cost alone is not a reasonable justification

   (See page 1-9 of the course material.)

4. A: Incorrect. Research studies have shown the response rates ranging from 66 to 96 percent.

   B: Correct. Studies have also shown somewhat lower detection rates for misstatements favorable to recipients (i.e., an accounts receivable understatement.)

   C: Incorrect. Overall, positive confirmations appear to be more effective than negative confirmations, but results vary depending on the type of recipients, the size of the accounts, and the type of account being confirmed.

   D: Incorrect. The response rate can be increased by using (a) a postcard sent in advance, notifying that a confirmation is coming, (b) special delivery mail, (c) first-class stamp postage (not metered), and (d) an envelope imprinted "Confirmation Enclosed: Please Examine Carefully."

   (See page 1-15 of the course material.)

5. **A: Correct.** Frequent ATM inquiries is one of many characteristic signs of check kiting schemes.

   B: Incorrect. It is more characteristic that many checks would be made payable to other banks.

   C: Incorrect. It would be more characteristic that large deposits would be made on Thursday or Friday to take advantage of the weekend.

   D: Incorrect. It would be more characteristic that there would be a short time lag between deposits and withdrawals rather than being held over a long period.

   (See page 1-20 of the course material.)

Chapter 2: Cash Disbursements and Payables

The acquisition and expenditure accounting cycle covers purchasing, receiving, accounts payable, and cash disbursements. This chapter contains sections on (1) typical control activities in the cycle, (2) the audit evidence available in management reports and data files, and (3) case story-style explanations concerning discovery of errors, and frauds. Special notes in the chapter cover (1) the completeness assertion, and (2) physical inventory observation.

ACQUISITION AND EXPENDITURE CYCLE: TYPICAL ACTIVITIES

The basic acquisition and expenditure activities are (1) purchasing goods and services and (2) paying the bills. Exhibit 2-1 shows the activities and transactions involved in an acquisitions and expenditure cycle. The exhibit also lists the accounts and records typically found in this cycle. As you follow the exhibit, you can track the elements of a control system described next.

AUTHORIZATION

Purchases are requested (requisitioned) by people who know the needs of the organization. A purchasing department seeks the best prices and quality and issues a purchase order to a selected vendor. Obtaining competitive bids is a good practice because it tends to produce the best prices and involves several legitimate suppliers in the process.

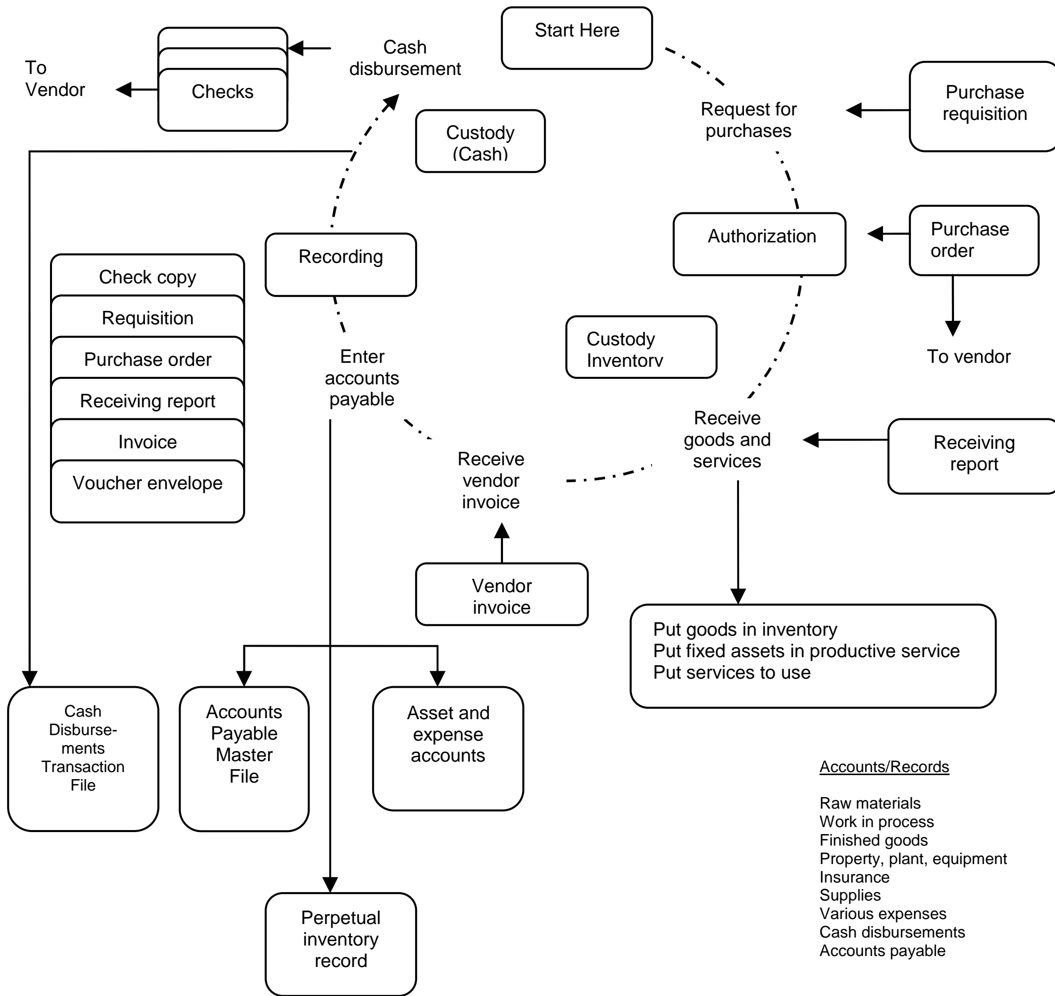
Cash disbursements are authorized by an accounts payable department's assembly of purchase orders, vendor invoices, and internal receiving reports to show a valid obligation to pay. This assembly of supporting documents is called a **voucher** (illustrated in Exhibit 2-1). Accounts payable obligations usually are recorded when the purchaser receives the goods or services ordered.

Checks are signed by a person authorized by the management or the board of directors. A company may have a policy to require two signatures on checks over a certain amount (e.g., $1,000). Vouchers should be marked "paid" or otherwise stamped to show that they have been processed completely so they cannot be paid a second time.

TOO MUCH TROUBLE

A trucking company self-insured claims of damage to goods in transit, processed claims vouchers, and paid customers from its own bank accounts. Several persons were authorized to sign checks. One person thought it "too much trouble" to stamp the vouchers PAID and said: "That's textbook stuff anyway." Numerous claims were recycled to other check signers, and $80,000 in claims were paid in duplicate before the problem was discovered.

EXHIBIT 2-1 Acquisition and Expenditure Cycle



CUSTODY

A receiving department inspects the goods received for quantity and quality (producing a *receiving report*), then puts them in the hands of other responsible persons (e.g., inventory warehousing, fixed asset installation). Services are not "received" in this manner, but they are accepted by responsible persons. Cash "custody" rests largely in the hands of the person or persons authorized to sign checks.

Another aspect of "custody" involves access to blank documents, such as purchase orders, receiving reports, and blank checks. If unauthorized persons can obtain blank copies of these internal business documents, they can forge a false purchase order to a fictitious vendor, forge a false receiving report, send a false invoice from a fictitious supplier, and prepare a company check to the fictitious supplier, thereby accomplishing an embezzlement.

RECORDING

When the purchase order, vendor's invoice, and receiving report are in hand, accountants enter the accounts payable, with debits to proper inventory, fixed asset, and expense accounts and with a credit to accounts payable. When checks are prepared, entries are made to debit the accounts payable and credit cash.

PERIODIC RECONCILIATION

A periodic comparison or reconciliation of existing assets to recorded amounts is not shown in Exhibit 2-1, but it occurs in several ways, including: physical inventory-taking to compare inventory on hand to perpetual inventory records, bank account reconciliation to compare book cash balances to bank cash balances, inspection of fixed assets to compare to detail fixed asset records, preparation of an accounts payable trial balance to compare the detail of accounts payable to the control account, and internal audit confirmation of accounts payable to compare vendors' reports and monthly statements to recorded liabilities.

CLASSIFY THE DEBITS CORRECTLY

Invoices for expensive repairs were not clearly identified, so the accounts payable accountants entered the debits that should have been repairs and maintenance expense as capitalized fixed assets. This initially understated expenses and overstated income by $125,000 one year, although the incorrectly capitalized expenses were written off as depreciation in later years.

AUDIT EVIDENCE IN MANAGEMENT REPORTS

Computer processing of acquisition and payment transactions enables management to generate several reports that can provide important audit evidence. Auditors should obtain and use these reports.

OPEN PURCHASE ORDERS

Purchase orders are "open" from the time they are issued until the goods and services are received. They are held in an "open purchase order" file. Generally, no liability exists to be recorded until the transactions are complete. However, auditors may find evidence of losses on purchase commitments in this file, if market prices have fallen below the purchase price shown in purchase orders.

THINKING AHEAD

Lone Moon Brewing purchased bulk aluminum sheets and manufactured its own cans. To assure a source of raw materials supply, the company entered into a long-term purchase agreement for 6 million pounds of aluminum sheeting at 40 cents per pound. At the end of this year, 1.5 million pounds had been purchased and used, but the market price had fallen to 32 cents per pound. Lone Moon was on the hook for a $360,000 (4.5 million pounds x 8 cents) purchase commitment in excess of current market prices.

UNMATCHED RECEIVING REPORTS

Liabilities should be recorded on the date the goods and services are received and accepted by the receiving department or by another responsible person. Sometimes, however, vendor invoices arrive later. In the meantime, the accounts payable department holds the receiving reports "unmatched" with invoices, awaiting enough information to record an accounting entry. Auditors can inspect the "unmatched receiving report" file report to determine whether the company has material unrecorded liabilities on the financial statement date.

UNMATCHED VENDOR INVOICES

Sometimes, vendor invoices arrive in the accounts payable department before the receiving activity is complete. Such invoices are held "unmatched" with receiving reports, awaiting information that the goods and services were actually received and accepted. Auditors can inspect the "unmatched invoice file" and compare it to the "unmatched receiving report" file to determine whether liabilities are unrecorded. Systems failures and human coding errors can cause "unmatched" invoices and related "unmatched" receiving reports to sit around unnoticed when all the information for recording a liability is actually in hand.

ACCOUNTS PAYABLE TRIAL BALANCE

This trial balance is a list of payable amounts by vendor, and the sum should agree with the accounts payable control account. (Some organizations keep records by individual invoices instead of vendor names, so the trial balance is a list of unpaid invoices. The sum still should agree with the control account balance.) The best kind of trial balance for audit purposes is one that contains the names of all the vendors with whom the organization has done business, even if their balances are zero. The audit "search for unrecorded liabilities" should emphasize the small and zero balances, especially for regular vendors, because these may be the places where liabilities are unrecorded.

All paid and unpaid accounts payable should be supported by a "voucher" or similar document. A "voucher" is a cover sheet, folder, or envelope that contains all the supporting documents--purchase requisition (if any), purchase order (if any), vendor invoice, receiving report (if any), and check copy (or notation of check number, date, and amount), as shown in Exhibit 2-1.

PURCHASES JOURNAL

A listing of all purchases may or may not be printed out. It may exist only in a computer transaction file. In either event, it provides raw material for (1) computer-audit analysis of purchasing patterns, which may exhibit characteristics of errors and frauds, and (2) sample selection of transactions for detail test of controls audit of supporting documents for validity, authorization, accuracy, classification, accounting/posting, and proper period recording. (A company may have already performed analyses of purchases, and auditors can use these for analytical evidence, provided the analyses are produced under reliable control conditions.)

INVENTORY REPORTS (TRIAL BALANCE)

Companies can produce a wide variety of inventory reports useful for analytical evidence. One is an item-by-item trial balance that should agree with a control account (if balances are kept in dollars). Auditors can use such a trial balance (1) to scan for unusual conditions (e.g., negative item balances, overstocking, and valuation problems) and (2) as a population for sample selection for a physical inventory observation (audit procedures to obtain evidence about the existence of inventory shown in the account). The scanning and sample selection may be computer-audit applications on a computer-based inventory report file.

THE SIGN OF THE CREDIT BALANCE

Auto Parts & Repair, Inc., kept perpetual inventory records and fixed assets records on a computer system. Because of the size of the files (8,000 parts in various locations and 1,500 asset records), the company never printed reports for visual inspection. Auditors ran a computer-audit "sign test" on inventory balances and fixed asset net book balances. The test called for a printed report for all balances less than zero. The auditors discovered 320 negative inventory balances caused by failure to record purchases and 125 negative net asset balances caused by depreciating assets more than their cost.

FIXED ASSET REPORTS

These reports are similar to inventory reports because they show the details of fixed assets in control accounts. They can be used for scanning and sample selection, much like the inventory reports. The information for depreciation calculation (cost, useful life, method, salvage) can be used for the audit of depreciation on a sample basis or by computer applications to recalculate all the depreciation.

CASH DISBURSEMENTS REPORTS

The cash disbursements process will produce a cash disbursements journal, sometimes printed out, sometimes maintained only on a computer file. This journal should contain the date, check number, payee, amount, account debited for each cash disbursement, and a cross-reference to the voucher number (usually the same as the check number). This journal is a population of cash disbursement transactions available for sample selection for detail test of controls audit of supporting documents in the voucher for validity, authorization, accuracy, classification, accounting/posting, and proper period recording.

SPECIAL NOTE: THE COMPLETENESS ASSERTION – SEARCH FOR UNRECORDED LIABILITIES

When considering assertions and obtaining evidence about accounts payable and other liabilities, auditors must put emphasis on the completeness assertion. (For asset accounts, the emphasis is on the existence assertion.) This emphasis on completeness is rightly placed because companies typically are less concerned about timely recording of expenses and liabilities than they are about timely recording of revenues and assets. Of course, generally accepted accounting principles require timely recording of liabilities and their associated expenses.

Evidence is much more difficult to obtain to verify the completeness assertion than the existence assertion. Auditors cannot rely entirely on a management assertion of completeness, even in combination with a favorable assessment of control risk (AU 9326). Substantive procedures – tests of details or analytical procedures--ought to be performed. The **search for unrecorded liabilities** is the set of procedures designed to yield audit evidence of liabilities that were not recorded in the reporting period. Such a search ought normally to be performed up to the report date in the period following the audit client's balance sheet date.

The following is a list of procedures useful in the search for unrecorded liabilities. The audit objective is to search all the places where evidence of them might exist. If these procedures reveal none, the auditors can conclude that all material liabilities are recorded.

1. Scan the open purchase order file at year-end for indications of material purchase commitments at fixed prices. Obtain current prices and determine whether any adjustments for loss and liability for purchase commitments are needed.
2. List the unmatched vendor invoices and determine when the goods were received, looking to the unmatched receiving report file and receiving reports prepared after the year-end. Determine which invoices, if any, should be recorded.

3. Trace the unmatched receiving reports to accounts payable entries, and determine whether ones recorded in the next accounting period need to be adjusted to report them in the current accounting period under audit.
4. Select a sample of cash disbursements from the accounting period following the balance sheet date. Vouch them to supporting documents (invoice, receiving report) to determine whether the related liabilities were recorded in the proper accounting period.
5. Trace the liabilities reported by financial institutions to the accounts. (See the Bank Confirmation in Exhibit 1-2, Chapter 1. However, a bank really is not expected to search all its files to report all client liabilities to auditors, so the bank confirmation is not the best source of evidence of unrecorded debts.)
6. Study IRS examination reports for evidence of income or other taxes in dispute, and decide whether actual or estimated liabilities need to be recorded.
7. Confirm accounts payable with vendors, especially regular suppliers showing small or zero balances in the year-end accounts payable. These are the ones most likely to be understated. (Vendors' monthly statements controlled by the auditors also may be used for this procedure.) Be sure to verify the vendors' addresses so confirmations will not be misdirected, perhaps to conspirators in a scheme to understate liabilities.
8. Study the accounts payable trial balance for indications of dates showing fewer payables than usual recorded near the year-end. (A financial officer may be stashing vendor invoices in a desk drawer instead of recording them.)
9. Review the lawyers' responses to requests for information about pending or threatened litigation, and for unasserted claims and assessments. The lawyers' information may signal the need for contingent liability accruals or disclosures.
10. Use a checklist of accrued expenses to determine whether the company has been conscientious about expense and liability accruals; including accruals for wages, interest, utilities, sales and excise taxes, payroll taxes, income taxes, real property taxes, rent, sales commissions, royalties, and warranty and guarantee expense.
11. When auditing the details of sales revenue, pay attention to the terms of sales to determine whether any amounts should be deferred as unearned revenue. Inquiries directed to management about terms of sales can be used to obtain initial information, such as inquiries about customers' rights of cancellation or return. (See the box below.)

ADVERTISED SALES RETURN PRIVILEGE

This advertisement appeared in popular magazines.

THE 1956 THUNDERBIRD – authentic die-cast replica of the classic T-Bird described as America's finest production sports car ever! Send no money now. You will be billed for a deposit of $24 and four equal monthly installments of $24 each.

RETURN ASSURANCE POLICY: If you wish to return any Franklin Mint Precision Models purchase, you may do so within 30 days of your receipt of that purchase for replacement, credit, or refund.

12. Prepare or obtain a schedule of casualty insurance on fixed assets, and determine the adequacy of insurance in relation to asset market values. Inadequate insurance and self-insurance should be disclosed in the notes to the financial statements.
13. Confirm life insurance policies with insurance companies to ask whether the company has any loans against the cash value of the insurance. In this confirmation, request the names of the beneficiaries of the policies. If the insurance is for the benefit of a party other than the company, the beneficiaries may be creditors on unrecorded loans. Make inquiries about the business purpose of making insurance proceeds payable to other parties.
14. Review the terms of debt due within one year but classified long-term because the company plans to refinance it on a long-term basis. Holders of the debt or financial institutions must have shown (preferably in writing) a willingness to refinance the debt before it can be classified long-term. Classification cannot be based solely on management's expressed intent to seek long-term financing.
15. Apply analytical procedures appropriate in the circumstances. In general, accounts payable volume and period-end balances should increase when the company experiences increases in physical production volume or engages in inventory stockpiling. Some liabilities may be functionally related to other activities; for example, sales taxes are functionally related to sales dollar totals, payroll taxes to payroll totals, excise taxes to sales dollars or volume, income taxes to income.

SPECIAL NOTE: PHYSICAL INVENTORY OBSERVATION

The audit procedures for inventory and related cost of sales accounts frequently are extensive in an audit engagement. A 96-page AICPA auditing procedure study entitled *Audit of Inventories* (AICPA, 1986) describes many facets of inherent risk, control risk, and the process of obtaining evidence about inventory financial statement assertions. Inventories often are the largest current asset.

A material error or fraud in inventory has a pervasive effect on financial statements. Errors in inventory cause misstatements in current assets, working capital, total assets, cost of sales, gross margin, and net income. While analytical procedures can help indicate inventory presentation problems, the auditors' best opportunity to detect inventory errors and frauds is during the physical observation of the client's inventory count taken by company personnel. (Auditors *observe* the inventory-taking and make *test counts*, but they seldom actually *take* (count) the entire inventory.) Auditing standards express the requirement for inventory observation in SAS 1, AU 331:

> Observation of inventories is a generally accepted auditing procedure. . . . When inventory quantities are determined solely by means of a physical count . . . it is ordinarily necessary for the independent auditor to be present at the time of count and, by suitable observations, tests, and inquiries, satisfy himself respecting the methods of inventory-taking and the reliance which may be placed upon the client's representation about the quantities and physical condition of the inventories.

The remainder of this special note gives details about auditors' observation of physical inventory-taking. The first task is to review the client's inventory-taking instructions. The instructions should include the following:

1. Names of client personnel responsible for the count.
2. Dates and times of inventory-taking.
3. Names of client personnel who will participate in the inventory-taking.
4. Instructions for recording accurate descriptions of inventory items, for count and double-count, and for measuring or translating physical quantities (such as counting by measures of gallons, barrels, feet, dozens).
5. Instructions for making notes of obsolete or worn items.
6. Instructions for the use of tags, punched cards, count sheets, computers, or other media devices and for their collection and control.
7. Plans for shutting down plant operations or for taking inventory after store closing hours, and plans for having goods in proper places (such as on store shelves instead of on the floor, or of raw materials in a warehouse rather than in transit to a job).
8. Plans for counting or controlling movement of goods in receiving and shipping areas if those operations are not shut down during the count.
9. Instructions for computer compilation of the count media (such as tags, count sheets) into final inventory listings or summaries.
10. Instructions for pricing the inventory items.
11. Instructions for review and approval of the inventory count; notations of obsolescence or other matters by supervisory personnel.

These instructions characterize a well-planned counting operation. As the plan is carried out, the independent auditors should be present to hear the count instructions being given to the client's count teams and to observe the instructions being followed.

Many physical inventories are counted at the year-end when the auditor is present to observe. The auditors can perform dual-direction testing by (1) selecting inventory items from a perpetual inventory master file, going to the location, and obtaining a test count, which produces evidence for the *existence assertion*; and (2) selecting inventory from locations on the warehouse floor, obtaining a test count, and tracing the count to the final inventory compilation, which produces evidence for the *completeness assertion*. If the company does not have perpetual records and a file to test for existence, the auditors must be careful to obtain a record of all the counts and use it for the existence-direction tests.

INVENTORY COUNT AND MEASUREMENT CHALLENGES

Examples	Challenges
Lumber	Problem identifying quality or grade.
Piles of sugar, coal, scrap steel	Geometric computations, aerial photos.
Items weighed on scales	Check scales for accuracy.
Bulk material (oil, grain, liquid in storage tanks)	Sample for assay or chemical analysis.
Diamonds, jewelry	Identification and quality problems. Ask a specialist.
Pulp wood	Quantity measurement estimation. Aerial photos.
Livestock	Movement not controllable. Count critter's legs then divide by four (two, for chickens)

Source (adapted: AICPA, *Audit of Inventories,* Auditing Procedures Study (1986), p.28

INVENTORY EXISTENCE AND COMPLETENESS

The physical observation procedures are designed to audit for existence and completeness (physical quantities), valuation (recalculation of appropriate FIFO, LIFO, or other pricing at cost, and lower-of-cost-or-market write-down of obsolete or worn inventory). After the observation is complete, auditors should have sufficient competent evidence of the following physical quantities and valuations:

- Goods in the perpetual records but not owned were excluded from the inventory compilation.
- Goods on hand were counted and included in the inventory compilation.
- Goods consigned-out or stored in outside warehouses (goods owned but not on hand) were included in the inventory compilation.
- Goods in transit (goods actually purchased and recorded but not yet received) were added to the inventory count and included in the inventory compilation.
- Goods on hand already sold (but not yet delivered) were not counted and were excluded from the inventory compilation.
- Goods consigned-in (goods on hand but not owned) were excluded from the inventory compilation.

INVENTORY – A RIPE FIELD FOR FRAUD

These problems have arisen in companies' inventory frauds:

- Auditors were fooled as a result of taking a small sample for test-counting, thus missing important information.
- Companies included inventory they pretended to have ordered.
- Auditors permitted company officials to follow them and notice their test counts. Then the managers falsified counts for inventory the auditors did not count.
- Shipments between plants (transfers) were reported as inventory at both plant locations.
- Auditors spotted a barrel whose contents management had valued at thousands of dollars, but it was filled with sawdust. The auditors required management to exclude the value from the inventory, but it never occurred to them that they had found one instance in an intentional and pervasive overstatement fraud.
- Auditors observed inventory at five store locations and told the management in advance of the specific stores. Management took care not to make fraudulent entries in these five stores, instead making fraudulent adjustments in many of the other 236 stores.
- After counting an inventory of computer chips, the auditors received a call from the client's controller: "Just hours after you left the plant, 2,500 chips arrived in a shipment in transit." The auditors included them in inventory but never checked to see whether the chips were real.

An accounting firm advised its audit personnel:

- Focus test counts on high-value items, and sample lower-value items. Test-count a sufficient dollar amount of the inventory.
- If all locations will not be observed, do not follow an easily predictable pattern. Advise client personnel as late as possible of the locations we will visit.
- Be skeptical of large and unusual test count differences or of client personnel making notes or displaying particular interest in our procedures and test counts.
- Be alert for inventory not used for some time, stored in unusual locations, showing signs of damage, obsolescence, or excess quantities.
- Ensure that interplant movements (transfers) are kept to an absolute minimum. Obtain evidence that any items added to inventory after the count is completed are proper and reasonable (i.e., exist in stated quality and quantity).

Source: *The Wall Street Journal* and Grant Thornton.

AUDIT CASES: SUBSTANTIVE AUDIT PROCEDURES

The audit of account balances consists of procedural efforts to detect errors, and frauds that might exist in the balances, thus making them misleading in financial statements. If such misstatements exist, they are characterized by the following features:

Method: A cause of the misstatement (accidental error, intentional irregularity, or fraud attempt), which usually is made easier by some kind of failure of controls.

Paper trail: A set of telltale signs of erroneous accounting, missing or altered documents, or a "dangling debit'' (the false or erroneous debit that results from an overstatement of assets).

Amount: The dollar amount of overstated assets and revenue, or understated liabilities and expenses.

The cases in this section tell about an error, irregularity, or fraud situation in terms of the method, the paper trail, and the amount. The first part of each case gives you the "inside story'' that auditors seldom know before they perform the audit work. The next part is an "audit approach'' section, which tells about the audit objective (assertion), controls, test of controls, and test of balances (substantive procedures) that could be considered in an approach to the situation. The "audit approach'' section presumes that the auditors do not know everything about the situation.

The audit approach part of each case contains the following parts:

Audit objective: A recognition of a financial statement *assertion* for which evidence needs to be obtained. The assertions are about existence of assets, liabilities, revenues, and expenses; their valuation; their complete inclusion in the account balances; the rights and obligations inherent in them; and their proper presentation and disclosure in the financial statements.

Control: A recognition of the control activities that *should be* used in an organization to prevent and detect errors and frauds.

Test of controls: Ordinary and extended procedures *designed to produce evidence about the effectiveness of the controls* that should be in operation.

Audit of balance: Ordinary and extended *substantive procedures designed to find signs* of errors and frauds in account balances and classes of transactions.

At the end of the chapter, some similar discussion cases are presented, and you can write the audit approach to test your ability to design audit procedures for the detection of errors and frauds.

CASE 2.1: PRINTING (COPYING) MONEY

Problem

Improper expenditures for copy services charged to motion picture production costs.

Method

Argus Productions, Inc., a motion picture and commercial production company, assigned M. Welby the authority and responsibility for obtaining copies of scripts used in production. Established procedures permitted Welby to arrange for outside script copying services, receive the copies, and approve the bills for payment. In effect, Welby was the "purchasing department" and the "receiving department" for this particular service. To a certain extent, Welby was also the "accounting department" by virtue of approving bills for payment and coding them for assignment to projects. Welby did not make the actual accounting entries or sign the checks.

M. Welby set up a fictitious company under the registered name of Quickprint Company with himself as the incorporator and stockholder, complete with a post office box number, letterhead stationery, and nicely printed invoices, but no printing equipment. Legitimate copy services were "subcontracted" by Quickprint with real printing businesses, which billed Quickprint. Welby then prepared Quickprint invoices billing Argus, usually at the legitimate shop's rate, but for a few extra copies each time. Welby also submitted Quickprint bills to Argus for fictitious copying jobs on scripts for movies and commercials that never went into production. As the owner of Quickprint, Welby endorsed Argus's checks with a rubber stamp and deposited the money in the business bank account, paid the legitimate printing bills, and took the rest for personal use.

Paper Trail

Argus's production cost files contained all the Quickprint bills, sorted under the names of the movie and commercial production projects. Welby even created files for proposed films that never went into full production, and thus should not have had script copying costs. There were no copying service bills from any shop other than Quickprint Company.

Amount

M. Welby conducted this fraud for five years, stealing $475,000 in false and inflated billings. (Argus's net income was overstated a modest amount because copying costs were capitalized as part of production cost, then amortized over a 2-3 year period.)

AUDIT APPROACH

Objective

Obtain evidence of the valid existence (occurrence) and valuation of copying charges capitalized as film production cost.

Control

Management should assign the authority to request copies and the purchasing authority to different responsible employees. The accounting, including coding cost assignments to projects, also should be performed by other persons. Managerial review of production results could result in notice of excess costs.

The request for the quantity (number) of copies of a script should come from a person involved in production who knows the number needed. This person also should sign off for the receipt (or approve the bill) for this requested number of copies, thus acting as the "receiving department." This procedure could prevent waste (excess cost), especially if the requesting person were also held responsible for the profitability of the project.

Actual purchasing always is performed by a company agent, and in this case, the agent was M. Welby. Purchasing agents generally have latitude to seek the best service at the best price, with or without bids from competitors. A requirement to obtain bids is usually a good idea, but much legitimate purchasing is done with sole-source suppliers without bid.

Someone in the accounting department should be responsible for coding invoices for charges to authorized projects, thus making it possible to detect costs charged to projects not actually in production.

Someone with managerial responsibility should review project costs and the purchasing practices. However, this is an expensive use of executive time. It was not spent in the Argus case. Too bad.

Test of Controls

In gaining an understanding of the control structure, auditors could learn of the trust and responsibility vested in M. Welby. Since the embezzlement was about $95,000 per year, the total copying cost under Welby's control must have been around $1 million or more. (It might attract unwanted attention to inflate a cost more than 10 percent.)

Controls were very weak, especially in the combination of duties performed by Welby and in the lack of managerial review. For all practical purposes, there were no controls to test, other than to see whether Welby had approved the copying cost bills and coded them to active projects. This provides an opportunity, since proper classification is a control objective.

Procedures: Select a sample of project files, and vouch costs charged to them to support in source documents (validity direction of the test). Select a sample of expenditures, and trace them to the project cost records shown coded on the expenditures (completeness direction of the test).

Audit of Balance

Substantive procedures are directed to obtaining evidence about the existence of film projects, completeness of the costs charged to them, valuation of the capitalized project costs, rights in copyright and ownership, and proper disclosure of amortization methods. The most important procedures are the same as the test of controls procedures; thus, when performed at the year-end date on the capitalized cost balances, they are dual-purpose audit procedures.

Either of the procedures described above as test of controls procedures should show evidence of projects that had never gone into production. (Auditors should be careful to obtain a list of actual projects before they begin the procedures.) Chances are good that the discovery of bad project codes with copying cost will reveal a pattern of Quickprint bills.

Knowing that controls over copying cost are weak, auditors could be tipped off to the possibility of a Welby-Quickprint connection. Efforts to locate Quickprint should be taken (telephone book, chamber of commerce, other directories). Inquiry with the state secretary of state for names of the Quickprint incorporators should reveal Welby's connection. The audit findings can then be turned over to a trained investigator to arrange an interview and confrontation with M. Welby.

Discovery Summary

In this case, internal auditors performed a review of project costs at the request of the manager of production, who was worried about profitability. They performed the procedures described above, noticed the dummy projects and the Quickprint bills, investigated the ownership of Quickprint, and discovered Welby's association. They had first tried to locate Quickprint's shop but could not find it in telephone, chamber of commerce, or other city directories. They were careful not to direct any mail to the post office box for fear of alerting the then-unknown parties involved. A sly internal auditor already had used a ruse at the post office and learned that Welby rented the box, but they did not know whether anyone else was involved. Alerted, the internal auditors gathered all the Quickprint bills and determined the total charged for nonexistent projects. Carefully, under the covert observation of a representative of the local district attorney's office, Welby was interviewed and readily confessed.

CASE 2.2: REAL CASH PAID TO PHONY DOCTORS

Problem

Cash disbursement fraud. Fictitious medical benefit claims were paid by the company, which self-insured up to $50,000 per employee. The expense account that included legitimate and false charges was "employee medical benefits."

Method

As manager of the claims payment department, Martha Lee was considered one of Beta Magnetic's best employees. She never missed a day of work in 10 years, and her department had one of the company's best efficiency ratings. Controls were considered good, including the verification by a claims processor that (1) the patient was a Beta employee, (2) medical treatments were covered in the plan, (3) the charges were within approved guidelines, (4) the cumulative claims for the employee did not exceed $50,000 (if over $50,000 a claim was submitted to an insurance company), and (5) the calculation for payment was correct. After verification processing, claims were sent to the claims payment department to pay the doctor directly. No payments ever went directly to employees. Martha Lee prepared false claims on real employees, forging the signature of various claims processors, adding her own review approval, naming bogus doctors who would be paid by the payment department. The payments were mailed to various post office box addresses and to her husband's business address.

Nobody ever verified claims information with the employee. The employees received no reports of medical benefits paid on their behalf. While the department had performance reports by claims processors, these reports did not show claim-by-claim details. No one verified the credentials of the doctors.

Paper Trail

The falsified claims forms were in Beta's files, containing all the fictitious data on employee names, processor signatures, doctors' bills, and phony doctors and addresses. The canceled checks were returned by the bank and were kept in Beta's files, containing "endorsements" by the doctors. Martha Lee and her husband were somewhat clever: They deposited the checks in various banks in accounts opened in the names and identification of the "doctors."

Martha Lee did not stumble on the paper trail. She drew the attention of an auditor who saw her take her 24 claims processing employees out to an annual staff appreciation luncheon in a fleet of stretch limousines.

Amount

Over the last seven years, Martha Lee and her husband stole $3.5 million, and, until the last, no one noticed anything unusual about the total amount of claims paid.

AUDIT APPROACH

Objective

Obtain evidence to determine whether employee medical benefits "existed'' in the sense of being valid claims paid to valid doctors.

Control

The controls are good as far as they go. The claims processors used internal data in their work--employee files for identification, treatment descriptions submitted by doctors with comparisons to plan provisions, and mathematical calculations.

This work amounted to all the approval necessary for the claims payment department to prepare a check.

There were no controls that connected the claims data with outside sources, such as employee acknowledgment or doctor investigation.

Test of Controls

The processing and control work in the claims processing department can be audited for deviations from controls.

Procedure: Select a sample of paid claims and reperform the claims processing procedures to verify the employee status, coverage of treatment, proper guideline charges, cumulative amount less than $50,000, and accurate calculation. However, this procedure would not help answer the question: "Does Martha Lee steal the money to pay for the limousines?''

"Thinking like a crook'' points out the holes in the controls. Nobody seeks to verify data with external sources. However, an auditor must be careful in an investigation not to cast aspersions on a manager by letting rumors start by interviewing employees to find out whether they actually had the medical claim paid on their behalf. If money is being taken, the company check must be intercepted in some manner.

Audit of Balance

The balance under audit is the sum of the charges in the employee medical benefits expense account, and the objective relates to the valid existence of the payments.

Procedure: The first procedure can be as follows: Obtain a list of doctors paid by the company and look them up in the state medical society directory. Look up their addresses and determine whether they are valid business addresses. You might try comparing claims processors' signatures on various forms, but this is hard to do and requires training. An extended procedure would be as follows: Compare the doctors' addresses to addresses known to be associated with Martha Lee and other claims processing employees.

Discovery Summary

The comparison of doctors to the medical society directory showed eight "doctors" who were not licensed in the current period. Five of these eight had post office box addresses, and discrete inquiries and surveillance showed them rented to Martha Lee. The other three had the same mailing address as her husband's business. Further investigation, involving the district attorney and police, was necessary to obtain personal financial records and reconstruct the thefts from prior years.

CASE 2.3: RECEIVING THE MISSING OIL

Problem

Fuel oil supplies inventory and fuel expense inflated because of short shipments.

Method

Johnson Chemical started a new contract with Madden Oil Distributors to supply fuel oil for the plant generators on a cost-plus contract. Madden delivered the oil weekly in a 5,000-gallon tank truck and pumped it into Johnson's storage tanks. Johnson's receiving employees were supposed to observe the pumping and record the quantity on a receiving report, which was then forwarded to the accounts payable department, where it was held pending arrival of Madden's invoice. The quantities received then were compared to the quantities billed by Madden before a voucher was approved for payment and a check prepared for signature by the controller. Since it was a cost-plus contract, Madden's billing price was not checked against any standard price.

The receiving employees were rather easily fooled by Madden's driver. He mixed sludge with the oil; the receiving employees did not take samples to check for quality. He called out the storage tank content falsely (e.g., 1,000 gallons on hand when 2,000 were actually in the tank); the receiving employees did not check the gauge themselves; and the tank truck was not weighed at entry and exit to determine the amount delivered. During the winter months, when fuel oil use was high, Madden ran in extra trucks more than once a week, but pumped nothing when the receiving employees were not looking. Quantities "received" and paid during the first year of the contract were (in gallons):

January	31,000	May	18,000	September	21,000
February	28,000	June	14,000	October	23,000
March	23,000	July	15,000	November	33,000
April	19,000	August	14,000	December	36,000

Paper Trail

The Johnson receiving reports all agreed with the quantities billed by Madden. Each invoice had a receiving report attached in the Johnson voucher files. Even though Madden had many trucks, the same driver always came to the Johnson plant, as evidenced by his signature on the receiving report (along with the Johnson company receiving employees' initials). Madden charged $1.80 per gallon, making the charges for the 275,000 gallons a total of $495,000 for the year. Last year, Johnson paid a total of $360,000 for 225,000 gallons, but nobody made a complete comparison with last year's quantity and cost.

CASE 2.3 : RECEIVING THE MISSING OIL – continued

Amount

During the first year, Madden shorted Johnson on quantity by 40,000 gallons (loss = 40,000 x $1.80 = $72,000) and charged 20 cents per gallon more than competitors (loss = 235,000 gallons x $0.20 = $47,000) for a total overcharge of $119,000, not to mention the inferior sludge mix occasionally delivered.

AUDIT APPROACH

Objective

Obtain evidence to determine whether all fuel oil billed and paid was actually received in the quality expected at a fair price.

Control

Receiving employees should be provided the tools and techniques they need to do a good job. Scales at the plant entrance could be used to weigh the trucks in and out and determine the amount of fuel oil delivered. (The weight per gallon is a well-known measure.) They could observe the quality of the oil by taking samples for simple chemical analysis.

Instructions should be given to teach the receiving employees the importance of their job so they can be conscientious. They should have been instructed and supervised to read the storage tank gauges themselves instead of relying on Madden's driver.

Lacking these tools and instructions, they were easy marks for the wily driver.

Test of Controls

The control activity supposedly in place was the receiving report on the oil delivered. A procedure to (1) take a sample of Madden's bills, and (2a) compare quantities billed to quantities received, and (2b) compare the price billed to the contract would probably not have shown anything unusual (unless the auditor became suspicious of the same driver always delivering to Johnson).

The information from the "understanding the control system'' phase would need to be much more detailed to alert the auditors to the poor receiving practices.

Procedure: Make inquiries with the receiving employees to learn about their practices and work habits.

Audit of Balance

The balances in question are the fuel oil supply inventory and the fuel expense.

The inventory is easily audited by reading the tank storage gauge for the quantity. The price is found in Madden's invoices. However, a lower-of-cost-or-market test requires knowledge of market prices of the oil. Since Johnson Chemical apparently has no documentation of competing prices, the auditor will need to make a few telephone calls to other oil distributors to get the prices. Presumably, the auditors would learn that the price is approximately $1.60 per gallon.

The expense balance can be audited like a cost of goods sold number. With knowledge of the beginning fuel inventory, the quantity "purchased," and the quantity in the ending inventory, the fuel oil expense quantity can be calculated. This expense quantity can be priced at Madden's price per gallon.

Analytical procedures applied to the expense should reveal the larger quantities used and the unusual pattern of deliveries, leading to suspicions of Madden and the driver.

Discovery Summary

Knowing the higher expense of the current year and the evidence of a lower market price, the auditors obtained the fuel oil delivery records from the prior year. They are shown below, and the numbers in parentheses are the additional gallons delivered in the current year.

Having found a consistent pattern of greater "use" in the current year, with no operational explanation, the auditors took to the field. With the cooperation of the receiving employees, the auditors read the storage tank measure before the Madden driver arrived. They hid in an adjoining building and watched (and filmed) the driver call out an incorrect reading, pump the oil, sign the receiving report, and depart. Then they took samples.

These observations were repeated for three weeks. They saw short deliveries, tested inferior products, and built a case against Madden and the driver.

Jan	28,000	(3,000)	July	10,000	(5,000)
Feb	24,000	(4,000)	Aug	9,000	(5,000)
March	20,000	(3,000)	Sept	15,000	(6,000)
April	17,000	(2,000)	Oct	20,000	(3,000)
May	13,000	(5,000)	Nov	28,000	(5,000)
June	11,000	(3,000)	Dec	30,000	(6,000)

CASE 2.4 : GO FOR THE GOLD

Problem

Fixed assets in the form of mining properties were overstated through a series of "flip" transactions involving related parties.

Method

In 20X5 Alta Gold Company was a public "shell" corporation that was purchased for $1,000 by the Blues brothers.

Operating under the corporate names of Silver King and Pacific Gold, the brothers purchased numerous mining claims in auctions conducted by the U.S. Department of the Interior. They invested a total of $40,000 in 300 claims. Silver King sold limited partnership interests in its 175 Nevada silver claims to local investors, raising $20 million to begin mining production. Pacific Gold then traded its 125 Montana gold mining claims for all the Silver King assets and partnership interests, valuing the silver claims at $20 million. (Silver King valued the gold claims received at $20 million as the fair value in the exchange.) The brothers then put $3 million obtained from dividends into Alta Gold, and, with the aid of a bank loan, purchased half of the remainder of Silver King's assets and all of Pacific Gold's mining claims by purchase. They paid off the limited partners. At the end of 20X5, Alta Gold had cash of $16 million and mining assets valued at $58 million, with liabilities on bank loans of $53 million.

Paper Trail

Alta Gold had in its files the partnership offering documents, receipts, and other papers showing partners' investment of $20 million in the Silver King limited partnerships. The company also had Pacific Gold and Silver King contracts for the exchange of mining claims. The $20 million value of the exchange was justified in light of the limited partners' investments.

Appraisals in the files showed one appraiser's report that there was no basis for valuing the exchange of Silver King claims, other than the price limited partner investors had been willing to pay. The second appraiser reported a probable value of $20 million for the exchange based on proved production elsewhere, but no geological data on the actual claims had been obtained. The $18 million paid by Alta to Silver King also had similar appraisal reports.

Amount

The transactions occurred over a period of 10 months. The Blues brothers had $37 million cash in Silver King and Pacific Gold, as well as the $16 million in Alta (all of which was the gullible bank's money, but the bank had loaned to Alta with the mining claims and production as security). The mining claims that had cost $40,000 were now in Alta's balance sheet at $58 million, the $37 million was about to flee, and the bank was about to be left holding the bag containing 300 mining claim papers.

AUDIT APPROACH

Objective

Obtain evidence of the existence, valuation, and rights (ownership) in the mining claim assets.

Control

Alta Gold, Pacific Gold, and Silver King had no control system. All transactions were engineered by the Blues brothers, including the hiring of friendly appraisers. The only control that might have been effective was at the bank in the loan-granting process, but the bank failed.

Test of Controls

The only vestige of control could have been the engagement of competent, independent appraisers. Since the auditors will need to use (or try to use) the appraisers' reports, the procedures involve investigating the reputation, engagement terms, experience, and independence of the appraisers. The auditors can use local business references, local financial institutions who keep lists of approved appraisers, membership directories of the professional appraisal associations, and interviews with the appraisers themselves.

Audit of Balances

The procedures for auditing the asset values include analyses of each of the transactions through all their complications, including obtaining knowledge of the owners and managers of the several companies and the identities of the limited partner investors. If the Blues brothers have not disclosed their connection with the other companies (and perhaps with the limited partners), the auditors will need to inquire at the secretary of state's offices where Pacific Gold and Silver King are incorporated and try to discover the identities of the players in this flip game. Numerous complicated premerger transactions in small corporations and shells often manipulate valuations.

Loan applications and supporting papers should be examined to determine the representations made by Alta in connection with obtaining the bank loans. These papers may reveal some contradictory or exaggerated information.

Ownership of the mining claims might be confirmed with the Department of Interior auctioneers or be found in the local county deed records (spread all over Nevada and Montana).

Discovery Summary

The inexperienced audit staff was unable to unravel the Byzantine exchanges, and they never questioned the relation of Alta to Silver King and Pacific Gold. They never discovered the Blues brothers' involvement in the other side of the exchange, purchase, and merger transactions. They accepted the appraisers' reports because they had never worked with appraisers before and thought all appraisers were competent and independent. The bank lost $37 million. The Blues brothers changed their names.

CASE 2.5 : RETREAD TIRES

Problem

Inventory and income overstated by substitution of retread tires valued for inventory at new tire prices.

Method

Ritter Tire Wholesale Company had a high-volume truck and passenger car tire business in Austin, Texas (area population 750,000). J. Lock, the chief accountant, was a longtime trusted employee who had supervisory responsibility over the purchasing agents as well as general accounting duties. Lock had worked several years as a purchasing agent before moving into the accounting job. In the course of normal operations, Lock often prepared purchase orders; but the manufacturers were directed to deliver the tires to a warehouse in Marlin (a town of 15,000 population 100 miles northeast of Austin). Ritter Tire received the manufacturers' invoices, which Lock approved for payment. Lock and an accomplice (brother-in-law) sold the tires from the Marlin warehouse and pocketed the money. At night, Lock moved cheaper retreaded tires into the Ritter warehouse so spaces would not seem to be empty. As chief accountant, Lock could override controls (e.g., approving invoices for payment without a receiving report), and T. Ritter (president) never knew the difference because the checks presented for signature were not accompanied by the supporting documents.

Paper Trail

Ritter Tire's files were well-organized. Each check copy had supporting documents attached (voucher, invoice, receiving report, purchase order), except the misdirected tire purchases had no receiving reports. These purchase orders were all signed by Lock, and the shipping destination on them directed delivery to the Marlin address. There were no purchase requisition documents because "requisitions" were in the form of verbal requests from salespersons.

There was no paper evidence of the retreaded tires because Lock simply bought them elsewhere and moved them in at night when nobody else was around.

Amount

Lock carried out the scheme for three years, diverting tires that cost Ritter $2.5 million, which Lock sold for $2.9 million. (Lock's cost of retread tires was approximately $500,000.)

AUDIT APPROACH

Objective

Obtain evidence of the existence and valuation of the inventory. (President Ritter engaged external auditors for the first time in the third year of Lock's scheme after experiencing a severe cash squeeze.)

Control

Competent personnel should perform the purchasing function. Lock and the other purchasing agents were competent and experienced. They prepared purchase orders authorizing the purchase of tires. (The manufacturers required them for shipments.)

A receiving department prepared a receiving report after counting and inspecting each shipment by filling in the "quantity column" on a copy of the purchase order. (A common form of receiving report is a "blind" purchase order that has all the purchase information except the quantity, which is left blank for the receiving department to fill in after an independent inspection and count.) Receiving personnel made notes if the tires showed blemishes or damage.

As chief accountant, Lock received the invoices from the manufacturers and approved them for payment after comparing the quantities with the receiving report and the prices with the purchase order. The checks for payment were produced automatically on the microcomputer accounting system when Lock entered the invoice payable in the system. The computer software did not void transactions for lack of a receiving report reference because many other expenses legitimately had no receiving reports.

The key weakness in the control system was the fact that no one else on the accounting staff had the opportunity to notice missing receiving reports in vouchers that should have had them, and Ritter never had the vouchers when checks were signed. Lock was a trusted employee.

Test of Controls

Because the control procedures for cross-checking the supporting documents were said to have been placed in operation, the external auditors can test the controls.

Procedure: Select a sample of purchases (manufacturers' invoices payable entered in the microcomputer), and (1) study the related purchase order for (i) valid manufacturer name and address; (ii) date; (iii) delivery address; (iv) unit price, with reference to catalogs or price lists; (v) correct arithmetic; and (vi) approval signature. Then (2) compare purchase order information to the manufacturers' invoice; and (3) compare the purchase order and invoice to the receiving report for (i) date, (ii) quantity and condition, (iii) approval signature, and (iv) location.

Audit of Balance

Ritter Tire did not maintain perpetual inventory records, so the inventory was a "periodic system'' whereby the financial statement inventory figure was derived from the annual physical inventory count and costing compilation. The basic audit procedure was to observe the count by taking a sample of locations on the warehouse floor, recounting the employees' count, controlling the count sheets, and inspecting the tires for quality and condition (related to proper valuation). The auditors kept their own copy of all the count sheets with their test count notes and notes identifying tires as "new'' or "retread.'' (They took many test counts in the physical inventory sample as a result of the test of controls work, described below.)

Discovery Summary

Forty manufacturers' invoices were selected at random for the test of controls procedure. The auditors were good. They had reviewed the business operations, and Ritter had said nothing about having operations or a warehouse in Marlin, although a manufacturer might have been instructed to "drop ship'' tires to a customer there. The auditors noticed three missing receiving reports, all of them with purchase orders signed by Lock and requesting delivery to the same Marlin address. They asked Lock about the missing receiving reports, and got this response: "It happens sometimes. I'll find them for you tomorrow.'' When Lock produced the receiving reports, the auditors noticed they were in a current numerical sequence (dated much earlier), filled out with the same pen, and signed with an illegible scrawl not matching any of the other receiving reports they had seen.

The auditors knew the difference between new and retread tires when they saw them, and confirmed their observations with employees taking the physical inventory count. When Lock priced the inventory, new tire prices were used, and the auditors knew the difference.

Ritter took the circumstantial evidence to a trained investigator who interviewed the manufacturers and obtained information about the Marlin location. The case against Lock led to criminal theft charges and conviction.

CASE 2.6 : AMORTIZE *BANG THE DRUM SLOWLY*

Problem

Net asset values (unamortized costs of films) were overstated by taking too little amortization expense.

Method

Candid Production Company was a major producer of theatrical movies. The company usually had 15-20 films in release at theaters across the nation and in foreign countries. Movies also produced revenue from video licenses and product sales (T-shirts, toys, and the like).

Movie production costs are capitalized as assets, then amortized to expense as revenue is received from theater and video sales and from other sources of revenue. The amortization depends on the total revenue forecast and the current-year revenue amount. As the success or failure of a movie unfolds at the box office, revenue estimates are revised. (The accounting amortization is very similar to depletion of a mineral resource, which depends upon estimates of recoverable minerals and current production.)

Candid Production was not too candid. For example, its recent film of *Bang the Drum Slowly* was forecast to produce $50 million total revenue over six years, although the early box office returns showed only $10 million in the first eight months in the theaters. (Revenue will decline rapidly after initial openings, and video and other revenue depend on the box office success of a film.)

Accounting "control" with respect to film cost amortization resides in the preparation and revision of revenue forecasts. In this case, they were overly optimistic, slowing the expense recognition and overstating assets and income.

Paper Trail

Revenue forecasts are based on many factors, including facts and assumptions about number of theaters, ticket prices, receipt sharing agreements, domestic and foreign reviews, and moviegoer tastes. Several publications track the box office records of movies. You can see them in newspaper entertainment sections and in industry trade publications. Of course, the production companies themselves are the major source of the information. However, company records also show the revenue realized from each movie.

Revenue forecasts can be checked against actual experience, and the company's history of forecasting accuracy can be determined by comparing actual to forecast over many films and many years.

Amount

Over a four-year period, Candid Productions postponed recognition of a $20 million amortization expense, thus inflating assets and income.

AUDIT APPROACH

Objective

Obtain evidence to determine whether revenue forecasts provide a sufficient basis for calculating film cost amortization and net asset value of films.

Control

Revenue forecasts need to be prepared in a controlled process that documents the facts and underlying assumptions built into the forecast. Forecasts should break down the revenue estimate by years, and the accounting system should produce comparable actual revenue data so forecast accuracy can be assessed after the fact. Forecast revisions should be prepared in as much detail and documentation as original forecasts.

Test of Controls

The general procedures and methods used by personnel responsible for revenue forecasts should be studied (inquiries and review of documentation), including their sources of information both internal and external. Procedures for review of mechanical aspects (arithmetic) should be tested: Select a sample of finished forecasts and recalculate the final estimate.

Specific procedures for forecast revision also should be studied in the same manner. A review of the accuracy of forecasts on other movies with hindsight on actual revenues helps in a circumstantial way, but past accuracy on different film experiences may not directly influence the forecasts on a new, unique product.

Audit of Balance

The audit of amortization expense concentrates on the content of the forecast itself. The preparation of forecasts used in the amortization calculation should be studied to distinguish underlying reasonable expectations from "hypothetical assumptions." A hypothetical assumption is a statement of a condition that is not necessarily expected to occur, but nonetheless is used to prepare an estimate. For example, a hypothetical assumption is like an "if-then" statement: "If *Bang the Drum Slowly* sells 15 million tickets in the first 12 months of release, then domestic revenue and product sales will be $40 million, and foreign revenue can eventually reach $10 million." Auditors need to assess the reasonableness of the basic 15 million ticket assumption. It helps to have some early actual data from the film's release in hand before the financial statements need to be finished and distributed. For actual data, industry publications ought to be reviewed, with special attention to competing films and critics' reviews (yes, movie reviews!).

Discovery Summary

The auditors were not skeptical enough about optimistic revenue forecasts, and they did not weigh unfavorable actual/forecast history comparisons heavily enough. Apparently, they let themselves be convinced by exuberant company executives that the movies were comparable with *Gone with the Wind*! The audit of forecasts and estimates used in accounting determinations is very difficult, especially when company personnel have incentives to hype the numbers, seemingly with conviction about the artistic and commercial merit of their productions. The postponed amortization expense finally came to roost in big write-offs when the company management changed.

SUMMARY

The acquisition and expenditure cycle consists of purchase requisitioning, purchase ordering, receiving goods and services, recording vendors' invoices and accounting for accounts payable, and making disbursements of cash. Companies reduce control risk by having a suitable separation of authorization, custody, recording, and periodic reconciliation duties. Error-checking procedures of comparing purchase orders and receiving reports to vendor invoices are important for recording proper amounts of accounts payable liabilities. Supervisory control is provided by having a separation of duties between preparing cash disbursement checks and actually signing them. Otherwise, many things could go wrong, ranging from processing false or fictitious purchase orders to failing to record liabilities for goods and services received.

Two topics have special technical notes in the chapter. The *completeness assertion* is very important in the audit of liabilities because misleading financial statements often have contained unrecorded liabilities and expenses. The "search for unrecorded liabilities'' is an important set of audit procedures. The *physical inventory observation* audit work gets a special section because actual contact with inventories (and fixed assets, for that matter) provides auditors with direct eyewitness evidence of important tangible assets.

Cash disbursement is a critical point for asset control. Many cases of embezzlement occur in this process. Illustrative cases in the chapter tell the stories of some of these schemes, mostly involving payment of fictitious charges to dummy companies set up by employees.

PRACTICAL CASE PROBLEMS
INSTRUCTIONS FOR CASES

These cases are designed like the ones in the chapter. They give the problem, the method, the paper trail, and the amount.

Please note: you are not required to complete this assignment as part of your CPE certification. However this exercise will reinforce your comprehension and ability to address the audit approach. If you choose to complete this exercise, in each of the following cases your assignment is to write the "audit approach" portion of the case, organized around these sections:

Objective: Express the objective in terms of the facts supposedly asserted in financial records, accounts, and statements.

Control: Write a brief explanation of desirable controls, missing controls, and especially the kinds of "deviations" that might arise from the situation described in the case.

Test of controls: Write some procedures for getting evidence about existing controls, especially procedures that could discover deviations from controls. If there are no controls to test, then there are no procedures to perform; go then to the next section. A "procedure" should instruct someone about the source(s) of evidence to tap and the work to do.

Audit of balance: Write some procedures for getting evidence about the existence, completeness, valuation, ownership, or disclosure assertions identified in your *objective* section above.

Discovery summary: Write a short statement about the discovery you expect to accomplish with your procedures.

Once you have completed writing the audit approach, sample responses are included for your review to compare your response to that suggested by the author.

CASE STUDY: LIKE A SON
Fictitious Vendors, Theft, and Embezzlement.

Write the "audit approach" section like the cases in the chapter.

Problem: Fictitious purchases overstated inventory and inflated costs and expenses, causing misstated financial statements and operating losses.

Method: Simon Construction Company had two divisions. Simon, the president, managed the roofing division. Simon delegated authority and responsibility for management of the modular manufacturing division to John G. A widower, Simon had virtually adopted John when he ran away from an orphanage 20 years earlier, treating him like the son he never had, even building him a fine house on the outskirts of the city.

John and his secretary handled all the bids for manufacturing jobs, purchased all the material, controlled the physical inventory of materials, contracted for shipping by truck, supervised the construction activity, billed the customers when jobs were in progress and finished, approved all bid changes, and collected payments from the customers. With Simons' approval, John asked the company internal auditor not to interfere with his busy schedule. The secretary entered all the division's transactions into the computerized accounting system from a dedicated terminal in the manufacturing division office.

John did everything crooked, and the secretary was an accomplice. He rigged low bids and gave kickbacks to customers' purchasing agents, paid high prices to suppliers and took kickbacks, set up dummy companies to sell materials to Simon Construction at inflated prices, removed excess materials inventory and sold it and took the money, manipulated the inventory accounts to overstate the inventory and hide the thefts, and caused Simon Construction to pay trucking bills for a side business he owned. Simon exercised no control over John's operations.

Paper trail: Paper evidence was plentiful, if somebody looked for it. Bid records showed original low bids, later raised for basic construction (e.g., adding second floor, when the original request for bid included a second floor). Checks payable to "cash" were endorsed by people known to be customers' purchasing agents. Prices paid for materials and supplies were higher than the list prices shown in the competing suppliers' price books kept in the manufacturing division library. John's kickbacks were deposited in his own bank account. Dummy companies were incorporated in the same state, with John and the secretary listed as original incorporators. The physical inventory shown in the accounts simply did not exist. Trucking bills showed deliveries to locations where the manufacturing division had no jobs in progress.

Amount: John drained $1.2 million from Simon Construction over a nine-year period before he was caught. Auditors were engaged to analyze the situation when Simon finally noticed the reported losses in the manufacturing division and had a violent argument with John.

AUDIT APPROACH:
LIKE A SON

Objective: Obtain evidence of the valid existence (occurrence) and valuation of materials and supplies used in construction and the physical quantities of materials inventory.

Control: Suitable control would provide for separation of duties among authority to initiate transactions, custody of assets, record-keeping, and reconciliation of assets with accounting records. If the business is too small to have numerous people employed, Simon should insist that the internal auditor be able to exercise review over purchasing, pricing, payments, and collections.

John had authority and influence over too many interrelated activities. Nothing he did was subject to review or supervision. In several different activities (purchase, transport, selling), he authorized transactions, had custody over assets, controlled the recording (through the accomplice secretary), and kept the internal auditor from performing any reconciling activity in the division.

The only thing John did not control was the independent auditor's work on the inventory observation and consequent discovery of overstated inventory. He also could not hide all the losses in the division, and apparently these were reported to some extent, because Simon finally noticed them.

Test of Controls: There are no controls to test. Auditors should go directly to audit of balances where a "dangling debit" might be hidden, and the most likely places are the materials inventory and the construction in progress. The procedures should be extensive.

However, test-of-controls type procedures can be used to find false and inflated transactions for the purpose of establishing the nature and extent of John's misdeeds. In this context, the procedures are applied with a substantive purpose:

- Select a sample of completed job files, and (1) prepare a schedule of bids and bid changes, and (2) trace final job billings to cash collections. (Try to find examples of actual cash embezzlement.)
- Select a sample of purchases (materials, trucking, etc.), and (1) compare delivery destinations to job sites, and (2) compare prices to price lists.
- Select a sample of vendors (suppliers, truckers, etc.), and investigate their addresses, business locations, and ownership for evidence of false fronts created by John.
- Select a sample of checks, including checks payable to "cash," and identify the endorsers (looking for kickback payments or connections to John).

Audit of Balance: The auditors should observe and simultaneously count all the inventory-taking, control a copy of the count sheets, and test all the pricing by reference to both invoice prices and suppliers' price lists. This extensive work should reveal any inventory shortage and inflated costs on jobs in progress.

Discovery Summary: Independent auditors had audited Simon Construction for five years. They never found the overstated inventory because they test-counted small samples and did not know enough about the materials to identify them correctly. They relied on invoice prices and never referred to list prices for a lower-of-cost-or-market test. They were influenced by the apparent close relation of President Simon and John, and were lulled into believing that a trusted employee could not do wrong. After all, losses were being reported in the manufacturing division, and the books balanced.

After being alerted by Simon's anger and suspicion, the auditors observed the inventory and construction in progress more extensively. They found the overstatements. They then performed tests listed above in the test of controls section and found evidence of all the conditions of John's perfidy. Simon confronted John. He confessed. The district attorney later obtained John's bank records and found confirming evidence of many unexplained deposits that came from his thefts.

CASE STUDY: THE BULGING DESK DRAWERS
Liability Understatement.

In this case, along with your "audit approach" solution, specify the discrepancies you notice by studying the excerpt from the accounts payable trial balance in the Case Exhibit on page 2-38. Also, recalculate the income before taxes and write the adjusting journal entry you would propose. (*Hint*: The voucher numbers in the trial balance are assigned when the vendor invoices are recorded.)

Problem: Failure to record purchases of raw materials and expense items caused understated accounts payable, understated cost of goods sold, understated expenses, and overstated income.

Method: All Bright Company manufactured lamps. L. Mendoza, the company financial vice president, knew the company was under pressure to produce profits in order to maintain its loans at the bank. One of the surest ways accountants know to produce profits with a pencil is to fail to record purchases. This keeps expenses off the books and understates cost of goods sold figured on a periodic inventory basis. (Cost of goods sold = Beginning inventory + Purchases - Ending inventory.)

Mendoza opened the mail each day and removed the invoices from suppliers, putting them in the office desk drawer. Later, when the company could "afford it," some invoices were sent to the accounts payable department for recording. Mendoza did not always get them in sequence of arrival, but that didn't matter much to her. Anyway, the desk drawers were getting full.

The clerks in the accounts payable department knew about this manipulation. They would go through periods with very little to record, then a large stack of invoices would be delivered for recording. (Must have made a big sale, they gossiped.)

The clerks followed control procedures about matching invoices with receiving reports, and they always had a full file of "unmatched receiving reports" awaiting the arrival of invoices. Mendoza had the power to override controls that called for the timely recording of purchases, and the clerks could not record invoices they had not yet received.

Paper trail: The accounts payable clerks gave each invoice-receiving report-purchase order set a voucher number in numerical sequence. They dated the accounts payable and related debit recordings on the day they processed the vouchers. Their vouchers were always complete because they were under strict orders not to record any payables that were not supported by source documents.

The problem with the paper trail is that the recording did not get started until Mendoza delivered the invoices. However, there was a file of the unmatched receiving reports in the accounts payable department, forwarded from the receiving employees, and there was a trial balance of accounts payable produced for the auditors.

An excerpt from this trial balance is in the Case Exhibit on page 2-38. The total accounts payable on the trial balance, not shown in the Case Exhibit on page 2-38, was $1.8 million for the year ended December 31, 20X5. (The signs of delayed recording of accounts payable are in the exhibit. Can you find them?)

Amount: Mendoza held back the recording of accounts payable for two years (the current year 20X5, and one year ago 20X4). One year ago, the accounts payable were understated by $500,000, of which $200,000 was unrecorded purchases for inventory and $300,000 was unrecorded operating expenses. In the current year (20X5), the accounts payable were understated at December 31 by $750,000, of which $450,000 was for inventory purchases, and $300,000 was unrecorded operating expenses.

The financial statements showed the following (dollars in 000s):

	Two Years Ago	One Year Ago	Current Year
Sales	$25,000	$29,000	$40,500
Cost of Goods Sold	(20,000)	(22,000)	(29,000
Expenses	(5,000)	(8,000)	(9,000)
Income (loss) before taxes	0	$(1,000)	$2,500
	==========	===========	==========
Ending inventory	$6,000	$8,000	$10,200
Current assets	9,000	8,500	17,500
Total assets	21,000	21,600	34,300
Current liabilities	5,000	5,500	13,000
Long-term debt *	5,500	6,600	9,300
Stockholder equity	10,500	9,500	12,000

** Secured by inventory pledged to the bank.*

CASE EXHIBIT Excerpt from Accounts Payable Trial Balance: December 31, 20X5

Voucher #	Vendor Name	Invoice #	Date Invoice	Date Due	Amount
26695	Industrial Uniforms	66681	01-Oct-X5	01-Nov-X5	112.11
26694	Industrial Uniforms	67127	08-Oct-X5	08-Nov-X5	112.11
27209	Industrial Uniforms	67582	15-Oct-X5	15-Nov-X5	112.11
27208	Industrial Uniforms	67981	22-Oct-X5	22-Nov-X5	112.11
27210	Industrial Uniforms	68462	29-Oct-X5	29-Nov-X5	112.11
27552	Industrial Uniforms	38972	05-Nov-X5	05-Dec-X5	112.11
27553	Industrial Uniforms	69463	12-Nov-X5	12-Dec-X5	112.11
27854	Industrial Uniforms	69851	19-Nov-X5	19-Dec-X5	112.11
29123	Industrial Uniforms	70851	03-Dec-X5	03-Jan-X6	112.11
28095	Industrial Uniforms	71353	10-Dec-X5	10-Jan-X6	112.11
29437	Industrial Uniforms	71831	17-Dec-X5	17-Jan-X6	112.11
	Vendor Total				1,233.21
					======
27484	B&B Experimental Co	17490	04-Nov-X5	04-Dec-X5	2,354.50
27550	B&B Experimental Co	17492	04-Nov-X5	04-Dec-X5	371.25
27559	B&B Experimental Co	17495	08-Nov-X5	08-Dec-X5	148.50
27560	B&B Experimental Co	17493	08-Nov-X5	08-Dec-X5	396.00
27741	B&B Experimental Co	17502	09-Nov-X5	09-Dec-X5	560.25
27475	B&B Experimental Co	17508	12-Nov-X5	12-Dec-X5	145.11
29494	B&B Experimental Co	17512	16-Nov-X5	16-Dec-X5	1,284.25
27556	B&B Experimental Co	17474	18-Nov-X5	18-Dec-X5	265.50
27662	B&B Experimental Co	17514	22-Nov-X5	22-Dec-X5	519.75
28084	B&B Experimental Co	17523	26-Nov-X5	26-Dec-X5	938.34
28085	B&B Experimental Co	17546	30-Nov-X5	30-Dec-X5	893.62
28086	B&B Experimental Co	17549	06-Dec-X5	06-Jan-X6	1,607.72
	Vendor Total				9,484.79
					======
29377	Cameo Corp	44298	06-Dec-X5	28-Feb-X6	1,429.02
29379	Cameo Corp	44300	06-Dec-X5	28-Feb-X6	1,747.93
29378	Cameo Corp	44413	07-Dec-X5	28-Feb-X6	259.33
29374	Cameo Corp	44412	07-Dec-X5	28-Feb-X6	808.33
29380	Cameo Corp	44415	07-Dec-X5	28-Feb-X6	844.71
29382	Cameo Corp	44414	07-Dec-X5	07-Feb-X6	1,553,19
29372	Cameo Corp	44596	09-Dec-X5	28-Feb-X6	3,781.01
29371	Cameo Corp	44682	10-Dec-X5	28-Feb-X6	1,262.59
29383	Cameo Corp	44684	10-Dec-X5	10-Feb-X6	4,094.82
29381	Cameo Corp	44681	10-Dec-X5	28-Feb-X6	926,51
29385	Cameo Corp	44685	10-Dec-X5	28-Feb-X6	3,750.44
29373	Cameo Corp	44680	10-Dec-X5	28-Feb-X6	1,124,78
29370	Cameo Corp	44983	10-Dec-X5	28-Feb-X6	3,973.39
	Vendor Total				25,556.05
					======
27120	Central States Pension		15-Apr-X5	15-Apr-X5	10,558.23
27121	Central States Pension		15-May-X5	15-May-X5	10,558.23
27122	Central States Pension		15-Jun-X5	15-Jun-X5	10,558.23
27123	Central States Pension		15-Jul-X5	15-Jul-X5	10,558.23
27124	Central States Pension		15-Aug-X5	15-Aug-X5	10,558.23
27125	Central States Pension		15-Sept-X5	15-Sept-X5	10,558.23
27126	Central States Pension		15-Oct-X5	15-Oct-X5	10,558.23
	Vendor Total				73,907.61
					=======

AUDIT APPROACH: THE BULGING DESK DRAWERS

In this case, along with your procedural solution, specify the discrepancies you notice by studying the excerpt from the accounts payable trial balance in the Exhibit. Also, recalculate the income before taxes and write the adjusting journal entry you would propose.

Objective: Obtain evidence about the completeness of accounts payable recording.

Control: The internal control structure should provide for timely delivery of vendors' invoices to the accounts payable department. Personnel should compare the invoices to receiving reports and purchase orders to determine whether the vendor billed for the quantity received at the price agreed in the purchase order. Voucher numbers should be assigned in numerical sequence, and each voucher should be recorded as of the date of receipt of the goods or services.

Control deviations occur when accounts payable get recorded for unauthorized purchases, for goods not received, in the wrong amount, or in the wrong accounting period.

Test of Controls: The process of obtaining an understanding of the control structure should include inquiries directed to Mendoza (internal control questionnaire) and to the accounting clerks who actually perform the accounts payable recording. Careful questioning should reveal information about their habits of recording dates on the day they make the entries instead of the dates of receipt of goods or services. Careful questioning about their mail delivery ought to elicit the information that it comes through Mendoza, and someone might even volunteer the well-known information that she holds invoices in the desk and delivers them to accounts payable on her own schedule.

In terms of procedures: Select a sample of recorded vouchers, paid and unpaid, and examine the supporting documents for evidence of matching quantities, prices, and dates of receipt and recording. Select a sample of "unmatched receiving reports," record the information, and wait until later to trace them to accounts payable entries later in the audit.

Audit of Balance: Send accounts payable confirmations to the vendors represented in the unmatched receiving reports file. (They are ones most likely to represent unrecorded liabilities.) Study the accounts payable trial balance for names of vendors with small or zero balances. Send confirmations to them. Study the trial balance for oddities, and notice these:

Vendor: Industrial Uniforms

Invoices of different dates were entered out of date sequence and apparently arrived in accounts payable at the same time:

- Oct 8 Industrial Uniforms invoice entered on voucher 26694 at same time the Oct 1 Industrial Uniforms invoice was entered on voucher 26695
- The "batching" happened again with the Oct 22 and Oct 15 invoices
- The Nov 5 and Nov 12 invoices were entered on consecutive vouchers numbered 27552 and 27553

There is a weekly billing pattern and the Nov 26 invoice is either not recorded or has been paid (unlikely, with all the unpaid invoices in weekly date sequence)

The Dec 10 invoice was recorded (voucher 28095) before the Dec 3 invoice was recorded (voucher 29123)

For a weekly billing pattern, the Dec 24 and Dec 31 invoices appear not to be recorded

Vendor: B&B Experimental

There seems to be only a few vouchers recorded in the Nov 26 - Dec 10 time period. B&B Experimental's Nov 26 invoice is recorded on voucher 28084, and Industrial Uniform's Dec 10 invoice was recorded on voucher 28095. The recording represents only 12 vouchers recorded in a 14-day period around the end/beginning of a month, when accountants might be expected to be recording payables to prepare monthly financial statements.

Two B&B invoices have the same Nov 2 date but appear to have been recorded at different times (one on voucher 27484, the other on voucher 27550. Although there's a voucher numbering gap (27550 - 27484 = 66), the recording might have been on the same day, one invoice might have later, or one might have been held without recording. Notice that the two Nov 8 invoices were recorded at the same time (consecutive vouchers 27559 and 27560).

The Nov 12 invoice was recorded (voucher 27475) before the Nov 4 invoice (voucher 27484) and several invoices following. The Nov 4 - Nov 9 invoices seem to have been held without recording until after the Nov 12 invoice was recorded. (Same out-of-sequence may be noted for the Nov 18 and Nov 22 invoices. Their recording comes before the recording of invoices with earlier dates.)

Judging from the recording of the Industrial Uniforms Dec 17 invoice on voucher 29437, the B&B Nov 16 invoice seems to have been recorded in Dec on voucher 29494, quite late. The dating seems to be confirmed when compared to Cameo's Dec 6 invoice recorded on voucher 29377.

B&B Experimental invoices seem to be dated about every 2-4 days, yet none are recorded after the invoice dated Dec 6. Either purchasing patterns changed or some Dec B&B invoices were not recorded.

A large number of vouchers seem to have been recorded around the same time. See B&B's Dec 6 invoice on voucher 28086 and Cameo's Dec 6 invoice on voucher 29377.

Vendor: Cameo Corp

The invoices seem to arrive at the rate of one or more per day, yet none are recorded after Dec 10. Probably invoices are being held back without recording.

Vendor: Central States Pension Fund

Apparently the company recorded all the monthly pension fund payments at one time (see the consecutive voucher numbers), and the time of recording must have been in Oct (judging from the Oct invoices from Industrial Uniforms recorded on vouchers in the low 27000's series).

It looks like the company paid the Jan - Mar liabilities, since they are not on the accounts payable trial balance. However, it looks like the Nov and Dec monthly payments due have not been recorded.

Discovery Summary: Inquiries elicited the gossip from the accounts payable clerks that Mendoza held invoices in the desk drawer. The study of the accounts payable trial balance provided documentary evidence after the sudden fire in Mendoza's office.

With the problem information, here are the restated financial statements:

	Two Years Ago	One Year Ago	Current Year
Sales	$25,000	$29,000	$40,500
Cost of Goods Sold	(20,000)	(22,200)	(29,250)
Expenses	(5,000)	(8,300)	(9,000)
Income (loss) before taxes	0	$(1,500)	$2,250
	==========	===========	==========
Ending inventory	$6,000	$7,500	$9,700
Current assets	10,000	12,000	23,000
Current liabilities	5,000	6,000	13,750
Long-term debt *	5,500	6,600	9,300
Total Assets	11,500	12,900	$24,500

** Secured by inventory pledged to the bank.*

Adjusting Journal Entry (20XX):

Cost of Goods Sold..........................	$ 450,000	
Operating Expenses..........................	$ 300,000	
Retained Earnings (prior period adjustment)..	$ 500,000	
Cost of Goods Sold..................................		$ 200,000
Operating Expenses..................................		$ 300,000
Accounts Payable....................................		$ 750,000

CHAPTER 2 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Cash custody rests largely with:

   a) the receiving department
   b) the person(s) authorized to sign checks
   c) the bank
   d) the purchasing department

2. The open purchase order file should be reviewed for evidence of:

   a) unpaid invoices
   b) fraud
   c) losses on purchase commitments
   d) material unrecorded liabilities

3. Which of the following reports can be used by an auditor to make a sample selection for identifying an overstocking issue:

   a) accounts payable trial balance
   b) purchases journal
   c) fixed asset report
   d) inventory trial balance

4. Through a physical inventory count, auditors can test for:

   a) the existence assertion
   b) the completeness assertion
   c) both a and b above
   d) none of the above

CHAPTER 2 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. The receiving department has custody of the goods received, but not the cash.

   B: Correct. Cash custody rests largely in the hands of the person or persons authorized to sign checks.

   C: Incorrect. The bank would not have responsibility for the receiving or disbursement of funds, and therefore would not have custody of the cash.

   D: Incorrect. The purchasing department generally does not handle the cash.

   (See page 2-3 of the course material.)

2. A: Incorrect. The accounts payable trial balance is a list of payable amounts by vendor, and can be reviewed to identify large unpaid invoices.

   B: Incorrect. The purchases journal may be reviewed for characteristics of errors and frauds.

   C: Correct. This would occur if prices have fallen below the purchase price shown in purchase orders.

   D: Incorrect. Material unrecorded liabilities can be found by inspecting the "unmatched receiving report" file report or the "unmatched invoice file."

   (See pages 2-4 to 2-5 of the course material.)

3. A: Incorrect. The accounts payable trial balance can be used to verify the accounts payable balance, and if listed by vendor, can be used to select vendors for confirmation purposes.

   B: Incorrect. The purchases journal provides raw materials for computer-audit analysis of purchasing patterns, which may exhibit characteristics of errors and frauds.

   C: Incorrect. The fixed asset report can be used for scanning and sample selection for auditing the fixed asset balance.

   D: Correct. The inventory trial balance should be detailed on an item-by-item basis, which will also provide the auditor with information to scan for other unusual conditions, including negative item balances and valuation problems.

   (See page 2-5 of the course material.)

4. A: Incorrect. The existence assertion can be tested by selecting inventory items from a perpetual inventory master file, going to the location, and obtaining a test count, but this is not the best answer.

   B: Incorrect. The completeness assertion can be tested by selecting inventory from locations on the warehouse floor, obtaining a test count, and tracing the count to the final inventory compilation, but this is not the best answer.

   C: Correct. Auditors can perform dual-direction testing at a physical inventory count, testing for both the existence and completeness assertions.

   D: Incorrect. Since there is a correct response given, none of the above cannot be correct.

   (See page 2-9 of the course material.)

Glossary

Account balance (substantive) audit program	A specification (list) of procedures designed to produce evidence about the assertions in financial statements.
Acquisition and Expenditure Accounting Cycle	Covers purchasing, receiving, accounts payable, and cash disbursements.
Amount (audit case situation)	The dollar amount of overstated assets and revenue, or understated liabilities and expenses.
Audit objective (audit approach section)	A recognition of a financial statement assertion for which evidence needs to be obtained.
Audit of balances (audit approach section)	Ordinary and extended substantive procedures designed to find signs of errors and frauds in account balances and classes of transactions.
Check kiting	The practice of building up balances in one or more bank accounts based on uncollected (float) checks drawn against similar accounts in other banks.
Confirmation forms (positive and negative)	Provide evidence of existence and, to a limited extent, of valuation of accounts and notes receivable.
Control (audit approach section)	A recognition of the control activities that should be used in an organization to prevent and detect errors and frauds.
Cutoff bank statement	An auditor's information source for vouching the bank reconciliation items which is a complete bank statement including all paid checks and deposit slips.
Detection rates	The ratio of the number of exceptions reported to auditors to the number of account errors intentionally reported to customers.
Embezzlement	To take for personal use money or property that has been given in trust by others, without their knowledge or permission.
Errors	Unintentional misstatements or omissions of amounts or disclosures in financial statements.

External auditors	Refers to independent CPAs who audit financial statements for the purpose of rendering an opinion.
Fraud	Knowingly making material misrepresentations of fact, with the intent of inducing someone to believe the falsehood and act upon it, and thus, suffer a loss or damage.
Internal auditors (Certified Internal Auditors)	Person who can be both independent and CPAs but are employed within organization.
Kiting	The process whereby cash is recorded in more than one bank account, but in reality, the cash is either nonexistent or is in transit.
Lapping	A method of concealing a defalcation, wherein cash received from a customer is originally misappropriated by the employee, and at a later date, cash received from another customer is credited to the first customer's account.
Method (audit case situation)	A cause of the misstatement (accidental error or fraud attempt), which usually is made easier by some kind of failure of controls.
Paper trail (audit case situation)	A set of telltales gins of erroneous accounting, missing or altered documents, or a "dangling debit" (the false or erroneous debit that results from an overstatement of assets).
Search for unrecorded liabilities	The set of procedures designed to yield audit evidence of liabilities that were not recorded in the reporting period.
Subpoena duces tecum	Ordinarily issued by a court or by a grand jury as a means to obtain documentary evidence – calls for the production of documents and records.
Substantive audit procedures	The detail audit and analytical procedures designed to detect material misstatements in account balances and footnote disclosures.
Test of controls (audit approach section)	Ordinary and extended procedures designed to produce evidence about the effectiveness of the controls that should be in operation.

Index

A

Acquisition and expenditure cycle, 2-1

B

Bank reconciliations, 1-21
Bank transfer schedule, 1-21

C

Cash disbursements and payables, 2-1, 2-42
Cash receipts journal, 1-7
Completeness assertion, 2-1, 2-6, 2-9, 2-31
Cutoff bank statement, 1-17, 1-21

E

Embezzlement, 2-3, 2-14, 2-31, 2-34, 2-44, 2-50
Existence assertion, 1-1, 1-7, 1-37

K

Kiting, 1-16, 1-19, 1-21, 1-42

L

Lapping, 1-16, 1-17, 1-12, 13-3

N

Negative confirmations, 1-12, 1-15

P

Periodic reconciliation, 2-3
Physical inventory observation, 2-1, 2-5, 2-31
Positive confirmations, 1-12, 1-15

R

Revenue and collection cycle, 1-1, 1-37, 1-41, 1-51

S

Search for unrecorded liabilities, 2-5, 2-6, 2-31, 2-44, 2-49
Standard bank confirmation form, 1-10, 1-39