

Cash Collections and Disbursements Fraud

Cash fraud schemes can hide in plain sight within receivables, payables, and everyday transactions. This course walks through real-world cases involving manipulated pricing, fictitious vendors, inventory schemes, and disbursement fraud — showing how these schemes work and how they get caught. Using detailed case studies, you'll explore analytical techniques, reconciliation practices, and the dual-purpose value of accounts receivable confirmations. Whether you work in audit, accounting, or tax, this course sharpens your ability to spot red flags before they become significant losses.

CREDIT HOURS 2 | FIELD OF STUDY AUDITING | EXAM QUESTIONS 10

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Identify audit procedures and fraud identification techniques appropriate for cash collections and receivables.
- Recognize procedures to perform for audit evidence related to cash disbursements and payables.

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Chapter 1: CASH COLLECTIONS AND RECEIVABLES

Chapter Objective

After completing this chapter, you should be able to:

- Identify audit procedures and fraud identification techniques appropriate for 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:

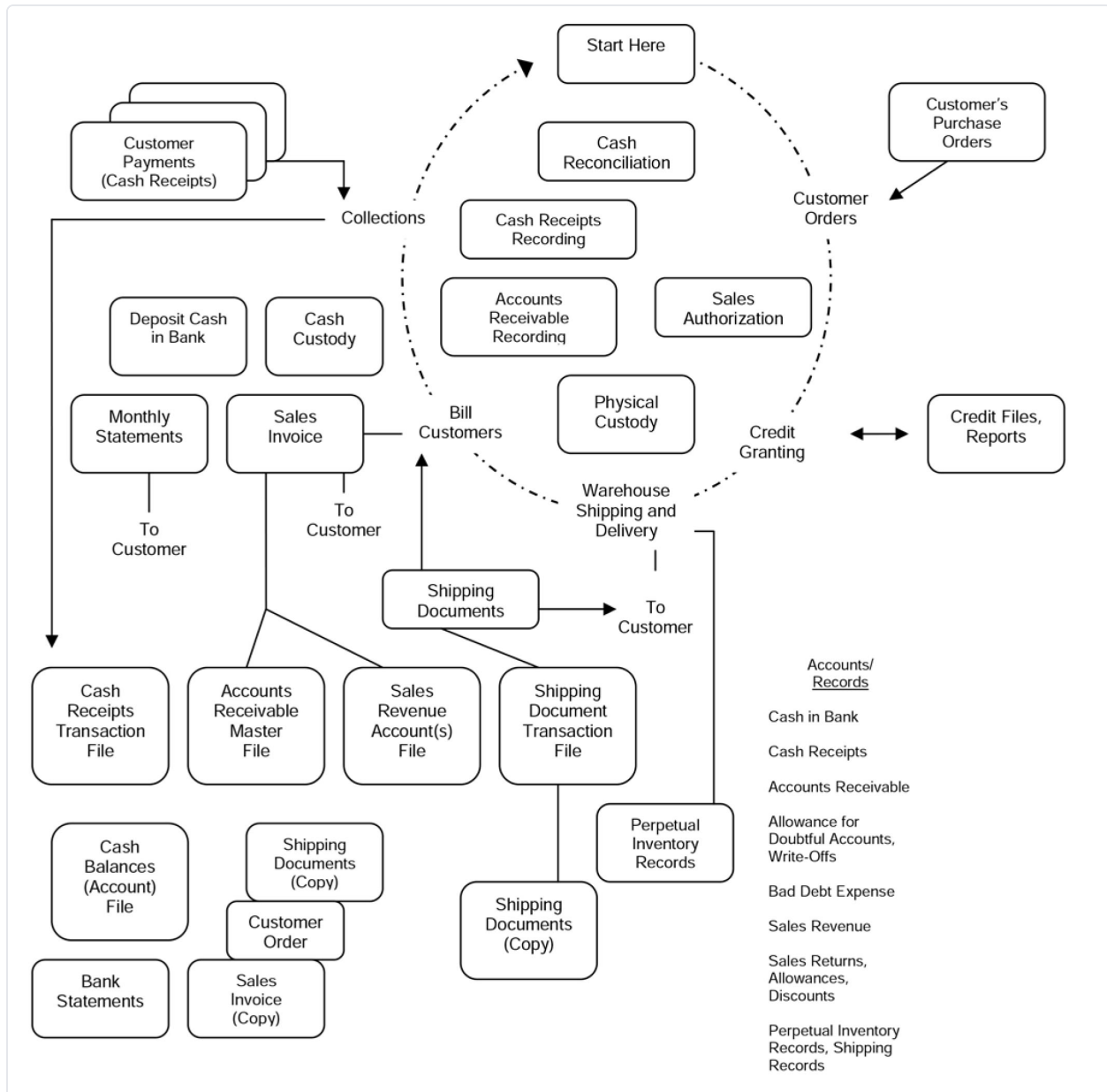
- (1) the existence assertion,
- (2) using confirmations,
- (3) bank reconciliation with attention to lapping and kiting, and
- (4) bank transfer and proof of cash analyses.

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

A computer system can 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