

Internal Controls For The Revenue Cycle: A Checklist For The Consumer Products Industry

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ABSTRACT

In today's difficult economic climate, business managers must carefully consider all aspects of business operations to minimize waste and increase efficiency. The revenue cycle continues to be the primary area of fraud and abuse requiring strong, comprehensive internal controls (AICPA 2002). Internal controls in the revenue arena are now more important than ever. The current paper provides a control review checklist for the revenue cycle that will aid managers and independent auditors in the consumer products industry. The checklist is applicable for firms at various levels of the distribution channel and can be used as a general benchmark to perform preliminary evaluations of a company's internal control system. Auditors can compare their company's control objectives with the objectives that are presented. During preliminary investigations of the company's internal control system, auditors should review whether important control objectives have been omitted and whether the omission incurs or heightens risk. The control review checklist can also be used by CFOs or Controllers in the Consumer Products industry in reviewing whether their company's internal control systems are adequate. The checklist provides CFOs or Controllers internal controls that external, independent auditors consider to be important.

Keywords: Internal control objectives and activities, consumer products industry

INTRODUCTION

The current paper presents a checklist that business managers and independent auditors in the consumer products industry can use to evaluate whether key revenue cycle internal controls are in place. The checklist is appropriate for publicly-traded and privately-held consumer products companies at various levels of the distribution channel. The checklist is both significant and timely in light of today's difficult economic environment in which the fraud risk level is high (AICPA 2002). Additionally, the checklist assists managers in addressing recent auditing standards triggered by the Sarbanes-Oxley Act of 2002 and the Public Company Accounting Oversight Board (PCAOB).

CONSUMER PRODUCTS INDUSTRY

Typically divided into durable and nondurable categories, the consumer products industry is a broadly defined industry that includes most items purchased by consumers. Important industry segments include appliances, beverages, electronics, food, and toiletries (Globoledge, 2009). While fostering and driving many ancillary industries, the consumer products industry is a major force in its own right and represents over half the world's volume of trade (Globoledge, 2009). Major industry manufacturers include General Electric, Procter & Gamble, and Unilever. Stores such as Wal-Mart, Sears, and Home Depot are major retailers within the industry. In developed economies, the industry is mature and characterized by stiff competition. Though raw material costs have leveled in 2009, recent increases have squeezed margins and required consumer products companies to increase prices and proactively address operational inefficiencies (Standard & Poor's, 2009). Suppressed earnings are forecasted for the near-term future, and managers within the industry must circumspectly review all operational fronts, including internal control systems (Standard & Poor's, 2009).

When addressing their internal control systems in today’s fraud-prone economic climate, managers must realize that independent auditors in the consumer products industry may increase their risk assessment for significant financial statement accounts such as revenue. Managers must be aware of the implications associated with an increase in assessed risk and should be prepared when independent auditors spend more time engaged in substantive testing of these significant accounts.

Managers must also realize that the nature, timing and extent of an independent auditor’s substantive testing will also be influenced by the auditor’s assessment of his or her client’s control risk. Given the heightened fraud risks associated with the revenue area, auditors in the consumer products industry are likely to exercise particular care while evaluating internal control systems in the revenue cycle. These evaluations will be especially influenced by recent developments associated with the Sarbanes-Oxley Act of 2002.

RECENT REGULATORY CHANGES

Managers of publicly-traded companies are required by Section 404 of the Sarbanes-Oxley Act to assess the effectiveness of internal control systems. The act also mandates that independent auditors report on this management assessment during the audit engagement. Two standards have been developed by the PCAOB to direct auditors in the preparation of these reports. The first standard is titled, “An Audit of Internal Control Over Financial Reporting Performed in Conjunction With An Audit of Financial Statements” (Standard No. 2, issued in March 2004). Superseding Standard No. 2, the next guideline is PCAOB Auditing Standard No. 5, “An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements” (Standard No. 5, issued in June 2007). The current paper’s checklist is consistent with PCAOB Standard No. 5 and can be used within combined or integrated audit engagements.

THE REVENUE CYCLE REVIEW CHECKLIST

Tables 1 and 2 present a checklist of control objectives and activities that should be referenced when conducting a preliminary audit of a consumer product firm’s revenue cycle. Table 1 lists significant revenue cycle control objectives. The objectives are followed by alpha numeric characters that reference the control activities listed in Table 2. The numeric portion of the reference explicitly refers to the control activities (listed numerically in Table 2), and the alpha portion (“F” or “P”) indicates whether or not the referenced activity “fully” or “partially” meets the given objective’s requirements.

Table 1 – Control Objectives and Suggested Control Activities

Control Objectives	Control Activities
Credits for all goods returned and adjustments to accounts receivable are issued in accordance with organization policy.	2P, 4F, 30F, 44P
All credits relate to a return of goods or other valid adjustments.	4F, 5P, 11P, 30P, 41P
Credits issued are recorded.	2P, 5F, 43P
Credits issued are recorded in the appropriate period.	5F, 38F
Sales are recorded in the appropriate period.	3P, 37F
Accounts receivable reflect the existing business circumstances and economic conditions in accordance with accounting policies being used.	6F
Cash registers are accounted for on a daily basis.	13F, 14P, 15P
All transactions are processed.	13F, 14P, 15P, 16P, 17P, 32F, 33P, 35P, 36F
Transactions are processed only once.	11P, 13F, 14P, 15P, 16P, 17P, 32F, 33P, 36F
Store deposits are made on a daily basis.	17P, 18P, 19P, 20P, 21P
Only valid changes are made to the file that connects merchandise codes, names and prices.	13F, 14P, 15P, 22P, 23P, 24P
Changes to the file that connects merchandise codes, names and prices are processed accurately.	13F, 14P, 15P, 22P, 23P, 24P
Changes to the file that connects merchandise codes, names and prices are processed timely.	13F, 14P, 15P, 22P, 23P, 24P
Price overrides are accurately recorded and monitored.	13F, 14P, 15P, 22P, 23P, 24P
Only authorized employees enter transactions.	25P, 26P, 27P
All credit card transactions are authorized.	28P, 29P
All POS transactions are recorded in the period in which they occur.	7F, 32F, 33F
POS transactions are processed accurately.	32F, 33P, 34P, 35P

Table 2 – Suggested Control Activities

1. Before goods are shipped, the details of the approved order are compared to the actual goods prepared for shipment by an individual independent of the order picking process.
2. Customer service calls and/or complaints are handled independently from transaction processing.
3. Recorded sales, gross margins, and miscellaneous receipts are compared to budget regularly; management reviews and approves significant variances.
4. A policy has been established regarding criteria for issuing credit notes (including evidence of the return of goods, the original cash register receipt, and/or other appropriate supporting documentation), time periods within which credit must be requested, and approval of such credits; compliance with this policy is monitored.
5. Credit notes are sequentially pre-numbered; the sequence of credit notes is accounted for.
6. Management reviews and approves the allowance for doubtful debts.
7. Cash receipts at, before, or after the end of an accounting period are scrutinized and/or reconciled to ensure complete and consistent recording in the appropriate accounting period.
8. Transfer orders are sequentially numbered. The sequence of orders processed is accounted for.
9. Management reviews relevant sales, cash receipts, costs of sales, and inventory reports related to sales at the POS terminal and cash receipts; significant unusual relationships are monitored and acted upon.
10. Sales, cash register receipts, and inventory management processing are performed by an integrated application system. The general ledger is automatically updated by this application system.
11. Personnel responsible for sales and cash receipts, sales audit, and adjustments to the general ledger have responsibility for only one such activity and have no system access to activities other than their assigned activity.
12. Shipping transaction input data is edited and validated; identified errors are corrected promptly.
13. Cash registers are properly closed every evening to prepare for the updating process.
14. Re-dial features in the updating process ensure that all stores are updated.
15. Built in balancing protocols in the updating process ensure the data is transmitted completely.
16. Sales audit function logs first and last transaction number on a daily basis to verify that no transactions are repeated or missed.
17. Sales audit function compares total sales updated to flash sales report printed at the store.
18. Blind store deposits are prepared by two individuals and approved by management.
19. Cash over/short amounts are tracked daily by store management and followed-up by sales audit.
20. A record of store deposits taken to the bank daily is maintained.
21. Store deposit slips are reconciled to the bank statements. Bank statements are then reconciled to the general ledger regularly.
22. All changes made to the file that connects merchandise codes, names and prices are approved by management.
23. The file that connects merchandise codes, names and prices is periodically reviewed by management for accuracy and on-going pertinence.
24. Store personnel or management have neither responsibility for maintenance nor update access to the file that connects merchandise codes, names and prices.
25. All POS terminals are physically protected (e.g., sales person or locked).
26. All personnel with access to a POS terminal has a unique ID and password.
27. Users are held accountable for activity performed on a POS terminal with their user ID.
28. All credit card transactions are signed by the customer.
29. Manual procedures requiring all sales greater than \$X (X is determined by management using the average price point of the company's transactions) are established when POS credit authorizations cannot be obtained.
30. All returned goods are logged when received. The log details such items as customers, goods, defects, inspections, and assessment by quality control. Return details per the log are compared to credit notes issued to ensure that credit is issued in the correct period and in accordance with company policy.
31. Shipments of goods to customers are logged. The log is used to ensure that all shipments are recorded.
32. Sales are recorded using a POS terminal/cash register. Customers are provided with a copy of the register receipt, and total daily receipts per the POS terminal/cash register are balanced to cash deposited to the bank.
33. Bank statements are reconciled to the general ledger regularly.
34. Cash receipts input data is edited and validated; identified errors are corrected promptly.
35. Cash receipts transactions are batched and batch input data is balanced; out-of-balance batches are corrected promptly.
36. Customers are provided with a form acknowledging receipt of any cash payments (i.e., a cash receipt form) and cash receipts forms are balanced to cash deposited to the bank. Cash receipt forms are sequentially pre-numbered and the sequence of such forms is accounted for.
37. Merchandise sold at, before, or after the end of an accounting period is scrutinized and/or reconciled to ensure complete and consistent recording in the appropriate accounting period, including the recording of the related cash receipt.
38. Goods returned by customers at, before, or after the end of an accounting period are scrutinized and/or reconciled to ensure complete and consistent recording in the appropriate accounting period.
39. The information system restricts to authorized personnel the ability to create, change, or delete sales orders, contracts, and delivery schedules.
40. The information system edits and validates order entry transactions on-line.
41. The information system restricts to authorized personnel the ability to create, change, or delete sales order return and credit note requests and subsequent credit note transactions.
42. The information system does not allow processing of sales orders that exceed customer credit limits.
43. The information system reports of invoices issued but not posted in finance are prepared and investigated promptly.
44. The information system matches sales order return and credit request transactions to invoices.
45. The information system reports of gaps in document numbering are reviewed regularly.

SUMMARY AND CONCLUSION

The current paper provides a checklist that, when used as a benchmark for comparative purposes, will aid managers and independent auditors in companies at all levels of the consumer products industry. The checklist will be useful in preliminarily assessing the design of internal controls in the revenue cycle. In light of today's difficult economic environment and recent modifications to PCAOB auditing standards, the checklist is both important and timely.

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