

UNIVERSITY OF TOLEDO INTERNAL AUDIT DEPARTMENT PROCESS ACCOUNTS RECEIVABLE, CREDIT, AND COLLECTIONS

Control practices

The following control objectives provide a basis for strengthening your control environment for the process of processing accounts receivable, credit, and collections. When you select an objective, you will access a list of the associated business risks and control practices. That information can serve as a checklist when you begin reviewing the strength of your current process controls.

This business risk and control information can help you assess your internal control environment and assist with the design and implementation of internal controls. Please note that this information is at the generic business process level and many companies will need to go beyond generic models to address the specific business processes that support the financial and nonfinancial disclosures being made. You can combine the insight of this business risk and control information with your industry-specific knowledge and understanding of your company's environment when conducting internal control assessments and designing and implementing recommendations.

Effectiveness and efficiency of operations

- A. Cash collections are facilitated and expedited.
- B. Cash receipts are safeguarded.
- C. Accounts receivable transactions are processed efficiently.
- D. Credit risk is managed to preserve margins and maximize cash flow while supporting business growth.
- E. Employees and management are given the information they need to control the accounts receivable management process.

Reliability of financial reporting

- A. Accounts receivable, cash receipts, and credit memos are properly authorized.
- B. Billing, accounts receivable, cash receipts, and credit memos are completely and accurately recorded on a timely basis.
- C. Billing, accounts receivable, cash receipts, and credit memos are reliably processed and reported.
- D. Credit and collections policies are properly authorized and executed.
- E. Recorded accounts receivable and sales balances are substantiated.
- F. Recorded accounts receivable and sales balances are evaluated.
- G. Accounts receivable employees are reliable.
- H. Performance measures used to control and improve the accounts receivable process are reliable.

Compliance with applicable laws and regulations

- A. Collections procedures comply with applicable laws and regulations.

Effectiveness and efficiency of operations

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A. Cash collections are facilitated and expedited.

Business risks

- The company will incur delays in collecting and processing cash receipts.

Control practices

1. Employ sophisticated collections procedures, such as lockboxes, depository accounts for customer remittances, EFT, and EDI or web-enabled billing, to improve the timeliness of receipts and accuracy of processing.
2. Employ varied accounts receivable methods to improve timeliness of cash receipts, such as factoring, discounts for timely remittances, multiple payment options, and outsourcing to collections agencies.
3. Craft performance measures that monitor the effectiveness of collections practices (measures such as days' sales outstanding and accounts receivable aging).

B. Cash receipts are safeguarded.

Business risks

- Cash will be lost or misappropriated.

Control practices

1. Deposit cash receipts intact daily.
2. Make wire transfers of cash remittances whenever possible.
3. Ensure physical controls over cash receipts are adequate (for example, prelist receipts, restrictive endorsements, daily deposits, reconciliation of book receipts with prelisted deposits, comparison of cash records with deposit slips and bank statements).
4. Write procedures that describe the responsibilities of every employee authorized to handle cash.
5. Ensure that physical access to cash receipts is limited to cash receipts personnel before the receipts are posted to the accounts receivable system.
6. Restrict employees with access to cash from having access to billing and account information.
7. Use lockboxes to handle incoming cash receipts.

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C. Accounts receivable transactions are processed efficiently.

Business risks

- Additional time and expense will be spent investigating errors, reconciling items, and reprocessing transactions.
- Cash collections will be delayed due to customer queries regarding errors.

Control practices

1. Design performance measures to monitor accounts receivable transaction processing (measures such as number of reconciling items between subsidiary and general ledgers, time to reconcile ledgers, time to reconcile prelisted receipts with bank deposits, and amount of unapplied cash outstanding).

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D. Credit risk is managed to preserve margins and maximize cash flow while supporting business growth.

Business risks

- The company will incur unacceptable credit losses.
- Excessively tight reins on credit allowances will result in lost business.

Control practices

1. Devise a credit policy that appropriately balances risk and profitability.
2. Focus credit policy on the following items: terms of sale (credit period, any cash discounts for early payment); account quality policy (determining how much credit to grant); and collections policy (collections methods, frequency, sample request letters, phone calls).
3. Administer the credit policy to be clear and consistent, cost-effective, respectful of long-term business relationships, and mindful of the need for business development.
4. Apply credit policy consistently.
5. Evaluate credit limits periodically and adjust according to customer financial conditions and payment patterns.
6. Use credit scoring to assign credit ratings that will trigger appropriate credit and collections practices.
7. Assign new customers initial credit limits and terms based on direct customer information and multiple credit histories.
8. Assess overall credit risk periodically by reviewing credit ratings, credit histories, trade references, and personal credit information via online access to credit bureaus.
9. Assign individual, variable credit limits to restrict customers.
10. Require high-risk customers to maintain deposits.
11. Process credit applications, including terms of payment, within hours of receipt.
12. Use a behavioral scoring system to update customer credit ratings by monitoring payment behaviors and account exposure.
13. Maintain a customer database of bad debt and high-risk customers to create better credit profiling and behavioral scoring systems.
14. Accelerate collections and withhold products to minimize the risk of loss from customers with financial difficulties.
15. Design performance measures to evaluate collections efforts.
16. Devise controls that detect customers who take cash discounts but do not pay within the discount period.
17. Secure credit insurance where unusual bad debt losses are anticipated.
18. Compare aged accounts receivable to prior years, industry standards, and competitors.
19. Summarize bad debt losses by customer, size of account, and terms of sale and analyze regularly.

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E. Employees and management are given the information they need to control the accounts receivable management process.

Business risks

- Information provided to employees and management about the billing process will conflict with company objectives.
- Employees will not improve the accounts receivable process on a timely basis.
- Employees and management will not be able to accurately determine whether the accounts receivable process is operating as planned.
- Plans to improve the accounts receivable process will be based on incorrect perceptions of process performance.

Control practices

1. Choose relevant performance measures that provide the information needed to control the accounts receivable process.
2. Probe the accounts receivable process to understand how it contributes to customer satisfaction and how the company's overall objectives drive performance measures.

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Reliability of financial reporting

A. Accounts receivable, cash receipts, and credit memos are properly authorized.

Business risks

- Revenue will be recorded for goods or services not shipped or provided.
- Invoiced sales will not be recorded; subsequent cash receipts will be misappropriated.
- Cash receipts will not relate to sales.
- Cash receipts will be incorrectly applied to customer accounts.
- Cash receipts will be lost, misappropriated, or diverted.
- Lost, incorrectly recorded, and/or misappropriated cash receipts will not be identified, so corrective action will not be taken, or will not be taken on a timely basis.
- Misappropriated collections will be concealed by invalid entries in the accounts.
- Credit memos will go recorded.
- Adjustments processed, such as credit memos, will not reflect good business practices. Adjustment errors will not be detected.
- Erroneous or fraudulent adjustments will not be detected.
- Collectable accounts will be written off to conceal misappropriations of cash receipts.

Control practices

1. Update the accounts receivable master file with authorized transaction data or cash receipts data.
2. Devise computer routines that automatically generate standard, recurring journal entries, update the general ledger, and summarize transaction activity.
3. Reconcile the accounts receivable subsidiary ledger regularly with the general ledger accounts receivable balance.
4. Employ security controls to prevent unauthorized access to the subsidiary and general ledger accounts receivable files.
5. Reconcile regularly between funds received and deposited in banks and amounts credited to customer accounts.
6. Reconcile regularly between the checks received in the mail and cash receipt transactions entered into the system.
7. Employ security controls that prevent unauthorized access to cash receipt transactions entered into accounting systems.
8. Ensure employees responsible for receipt and deposit of checks are not responsible for posting to ledgers, collecting delinquent receivables, authorizing write-offs or credit memos, or preparing billing documents.
9. Employ security controls that prevent unauthorized issuance of credit memo transactions within the system.
10. Require management approval for all adjustments to the receivable balances other than credit memos.

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B. Billing, accounts receivable, cash receipts, and credit memos are completely and accurately recorded on a timely basis.

Business risks

- Documents will be missing or information will be incorrect.
- Incorrect aging will result in delinquent customer remittances or the write-off of delinquent accounts.
- Detailed postings to the subsidiary ledger accounts or records will not agree with the total activity posted to the accounts receivable control account due to unrecorded or inaccurately recorded invoices or cash receipts.
- Accounts receivable will be credited for amounts that do not represent actual collections of receivables on account.
- Cash receipts will be incorrectly recorded due to clerical or mechanical errors.
- Cash receipts will differ from invoiced amounts or will not be applied to specific billings.
- Cash receipts will not be summarized and posted on a timely basis.
- Source data for journal entries will be duplicated and/or erroneous.
- Sales transactions will be improperly coded.
- Invoices for shipments and services will not be summarized and posted on a timely basis.
- Cash receipt transactions will be improperly coded.
- Detailed activity will be incorrectly posted in subsidiary accounts.
- Postings to the revenue and receivable accounts in the general ledger will be incomplete and inaccurate.

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Control practices

1. Reconcile regularly the amounts billed with the amounts recorded in the accounts receivable subsidiary ledger and general ledger.
2. Use third parties (for example, lockboxes, EFT, outsourcers) to receive cash receipts.
3. Ensure that the electronic filing of receipts into the lockbox interfaces with the accounts receivable sub-ledger and applies cash receipts to the customer accounts based on a matching of customer name, customer number, and invoice number.
4. Require cash posting personnel to reconcile control totals of the cash receipts received for the day (from lockbox files/reports) with the total of cash receipts applied to customer accounts.
5. Require cash posting personnel to reconcile the control totals from the cash receipts received for the day (from lockbox files/reports) with the total of cash receipts that are applied to customer accounts.
6. Assign employees outside the accounts receivable process to open the mail and prelist the receipt of funds received.
7. Reconcile total amount of cash receipts entered into the system against the amount credited to the accounts receivable subsidiary ledger.
8. Pre-number and account for credit memos and receiving documents.
9. Validate accounting systems credit memo data against receiving record and invoice record data during processing.
10. Build accounting systems that create journal entries that summarize transaction activity in accounts receivable subsidiary ledgers and update these entries to the general ledger master files.
11. Review detailed accounts receivable aging by customer monthly.
12. Investigate any long-outstanding or other unusual credit balances.

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C. Billing, accounts receivable, cash receipts, and credit memos are reliably processed and reported.

Business risks

- Loss, destruction, or alteration of accounts receivable records will preclude collection of outstanding balances.
- Unauthorized changes to programs will cause unauthorized processing results.
- Use of unauthorized versions of files and/or programs will result in unauthorized or incorrect business transactions.
- Inefficiencies, lost assets, and/or incorrect transactions will result from lost, altered, or damaged files (transaction, reference, or master).
- Unauthorized inputs will occur, leading to nonexistent returns, allowances, and write-offs.

Control practices

1. Employ security controls that restrict the ability to modify programs to authorized individuals only.
2. Review correspondence authorizing sales returns and allowances.
3. Use only authorized versions of programs and master files to process transactions.

D. Credit and collections policies are properly authorized and executed.

Business risks

- Credit review will be inconsistent and/or inadequate.
- Products will be sold to unauthorized customers or to unacceptable credit risks, resulting in uncollectible accounts.
- Delinquent accounts will need to be written off due to inadequate collection efforts.

Control practices

1. Devise a formal, written set of approved credit policies and procedures.
2. Establish credit limits for each customer or customer type.
3. Maintain a listing of all customers who qualify for credit that includes specific credit terms and require management approval for any additions to the list.
4. Review approved credit limits and current receivable balances prior to accepting and shipping new customer orders.
5. Assign the collections group to regularly review accounts receivable balances (both debits and credits).
6. Employ the collections group to initiate collection efforts for account balances outstanding beyond the specified terms of the sale.

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E. Recorded accounts receivable and sales balances are substantiated.

Business risks

- Unrecorded transactions will remain undetected.
- Errors in processing, summarizing, and recording sales transactions will remain undetected.
- Goods shipped and services rendered will not be recorded or billed.

Control practices

1. Segregate the accounts receivable subsidiary ledger function from the preparation of accounts receivable documentation, maintenance of the control account, and handling of cash receipts.
2. Reconcile the accounts receivable subsidiary ledger to the general ledger periodically.
3. Send customers statements of their balances periodically.
4. Compare accounts receivable balances periodically to budgeted amounts, prior period amounts, and industry statistics.

F. Recorded accounts receivable and sales balances are evaluated.

Business risks

- Recorded balances will not be reasonably stated in light of environmental conditions existing at a particular date.

Control practices

1. Use a valuation reserve policy that states receivables at their net realizable value.
2. Compare provisions, write-offs, and credit memos with budgets and historical information and with economic and industry conditions periodically to ensure the reserves are adequate.
3. Employ accounting systems to prepare aged receivable analyses and reconcile those analyses with the control balance and address past due items.

G. Accounts receivable employees are reliable.

Business risks

- Receivables due from terminated employees will not be collected.

Control practices

1. Maintain records and aged receivable balances due from employees, including travel advances, and review and reconcile these periodically.

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H. Performance measures used to control and improve the accounts receivable process are reliable.

Business risks

- Inaccurate measures will result in erroneous perceptions about process performance and lead to inappropriate decisions.

Control practices

1. Collect data to assess performance according to the performance measures selected by management.
2. Calculate performance measures automatically using computer systems.
3. Review performance measures periodically to ensure they represent optimal process performance.

Compliance with applicable laws and regulations

A. Collections procedures comply with applicable laws and regulations.

Business risks

- The company will incur fines or other penalties for noncompliance.
- The company will incur bad publicity and loss of reputation.

Control practices

1. Require legal review of all relevant laws and regulations pertaining to credit and collections practices.
2. Assign the legal department to review credit and collections policies and procedures to ensure they comply with laws and regulations.
3. Designate a legal officer to oversee legal and regulatory compliance for the credit and collections process.