Chapter 18

Audit of the Acquisition and Payment Cycle: Tests of Controls, Substantive Tests of Transactions, and Accounts Payable

■ Concept Checks

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1. There are several balance sheet and income statement accounts related to the acquisition and payment cycle as shown in Figure 18-1. The most significant balance sheet accounts are cash in bank; property, plant, and equipment; accounts payable; and other accrued liabilities. The most significant income statement accounts are COGS accounts (including purchases), depreciation expense, income tax expense, and other possibly significant accounts such as administrative expense, rent expense, repairs and maintenance, or legal expense.

2. A voucher is a document used by an organization to establish a formal means of recording and controlling acquisitions. A voucher register is a journal for recording the vouchers for the acquisition of goods and services. The use of a voucher system improves control over the recording of purchases by facilitating the recording in numerical order at the earliest possible date, which is the point at which the invoice is received.

3. The point at which goods and services are received is ordinarily when title to the goods and services passes and a liability that should be included in the financial statements is established.

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1. The acquisition and payment cycle includes the recording of liabilities that are set up in the accounts payable account. If the auditor finds that the internal controls in the acquisition and payment cycle are sufficient to ensure that accounts payable are recorded in the proper amount and at the proper time, reconciling the vendors' statements and testing the cutoff as year-end procedures of the accounts payable balance may be greatly reduced.

2. It is important that the cutoff of accounts payable be coordinated with that of the physical inventory to determine that they are established at the same point in time. If these cutoffs are not consistent, goods may be counted in the physical inventory for which no liability in accounts payable has been

recorded, or vice versa. Such a situation would result in an understatement of accounts payable and cost of goods sold or an overstatement of these two accounts, respectively. During the physical inventory, the auditor should gather cutoff information (such as the last several receiving reports and shipping documents) to assist in the determination that an accurate cutoff was established.

3. To test for completeness of accounts payable, the auditor conducts various out-of-period liability tests (also called a search for unrecorded accounts payable) designed to uncover unrecorded accounts payable. These tests include examining underlying documentation for cash disbursements occurring subsequent to year-end and verifying that a liability is recorded at year-end if appropriate; examining underlying documentation for bills that are still not paid several weeks after year-end; tracing receiving reports issued before year-end to the related vendors' invoices and making sure they are included in accounts payable; examining vendors' statements as of year-end and tracing to accounts payable; and sending confirmations to vendors with which the client does business.

■ Review Questions

18-1 The accounts in the acquisition and payment cycle are the following:

a. Asset accounts:

- Office supplies
- Delivery equipment
- Machinery and equipment
- Land
- Cash in bank
- Prepaid expenses

b. Liability accounts:

- Accounts payable
- Accrued property taxes
- Accrued insurance
- Other accrued liabilities

c. Expense accounts:

- Purchases, purchase returns & allowances, purchases discounts (COGS accounts)
- Rent expense
- Legal expense

18-1 (continued)

- Fines and penalties
- Advertising expense
- Repairs and maintenance
- Depreciation expense
- Utilities expense
- Property tax expense
- Administrative expenses
- Income tax expense

18-2 A vendor's invoice is sent with or at the same time as the order and states the amount of goods shipped, the price, and other details. This is the vendor's bill for the goods shipped. A vendor's statement contains the individual open items and the ending balance due in the account. A vendor's statement is not as meaningful as an invoice to verify individual transactions because a statement includes only the total amount of the transactions and not the details making up the shipment, such as unit price and freight. The vendor's statement can be used to verify the correct balance in accounts payable for an individual vendor. The statement contains the ending balance and the individual transactions required to reconcile the accounts payable listings and determine the propriety of the balances shown for individual vendors.

18-3 It is difficult to control blank or voided checks (as well as checks issued before they are mailed) without having a printed prenumbered system of blank checks. Without prenumbering, unauthorized and unrecorded checks may be more easily issued without detection until after they have cleared the bank. The auditor can compensate for poor control over checks by reconciling recorded cash disbursements with cash disbursements on the bank statement for a test period.

18-4

TRANSACTION-RELATED AUDIT OBJECTIVE	POSSIBLE INTERNAL CONTROLS	COMMON TESTS OF CONTROLS
1. Recorded cash disbursements are for goods and services actually received (occurrence).	■ There is adequate segregation of duties between accounts payable and custody of signed checks. ■ Supporting documentation is examined before signing of checks by an authorized person. ■ Approval of payment noted on supporting documents at the time checks are signed.	■ Discuss with personnel and observe activities. ■ Discuss with personnel and observe activities. ■ Examine indication of approval.
2. Existing cash disbursement transactions are recorded (completeness).	■ Checks are prenumbered and accounted for. ■ The bank reconciliation is prepared monthly by an employee independent of recording cash disbursements or custody of assets.	■ Account for a sequence of checks. ■ Examine bank reconciliations and observe their preparation.
3. Recorded cash disbursement transactions are accurate (accuracy).	■ Calculations and amounts are internally verified. ■ The bank reconciliation is prepared monthly by an independent person.	■ Examine indication of internal verification. ■ Examine bank reconciliations and observe their preparation.
4. Cash disbursement transactions are properly included in the accounts payable master file and are properly summarized (posting and summarization).	■ Accounts payable master file contents are internally verified. ■ Accounts payable master file or trial balance totals are compared with general ledger balances.	■ Examine indication of internal verification. ■ Examine initials on general ledger accounts indicating comparison.
5. Cash disbursement transactions are properly classified (classification).	■ An adequate chart of accounts is used. ■ Account classifications are internally verified.	■ Examine procedures manual and chart of accounts. ■ Examine indication of internal verification.
6. Cash disbursement transactions are recorded on the correct dates (timing).	■ Procedures require recording of transactions as soon as possible after the check has been signed. ■ Dates are internally verified.	■ Examine procedures manual and observe whether unrecorded checks exist. ■ Examine indication of internal verification.

18-5 The two broad areas into which tests of controls and substantive tests of transactions for the acquisition and payment cycle are divided are:

1. Tests of acquisitions, including controls and substantive tests on purchase orders, receiving goods and services, and recognizing the liability.
2. Tests of payments primarily related to processing and recording cash disbursements.

18-6 Auditing standards require that the tests of controls and substantive tests of transactions cover the entire accounting period in order to determine that the system was operating in a consistent manner throughout the period. In selecting the number of items for testing, the auditor must determine the sample size, statistically or nonstatistically, such that it is likely to be representative of the actual conditions of the population of all transactions during the entire period.

In testing items that are periodic procedures rather than individual transactions (such as monthly bank reconciliations), the auditor must determine the appropriate timing to determine that those procedures are operating properly.

18-7 The four key internal controls over the acquisition and payment cycle are similar to effective internal controls in general, as related to:

1. authorization of purchases
2. separation of duties;
3. proper and timely recording of transactions; and
4. authorization of payments.

Related to each of these controls, the audit of internal controls will consider the following:

RELATED INTERNAL CONTROL	EXAMPLES OF EFFECTIVE CONTROLS
Authorization of purchases	▪ Requisition requests should only be submitted by authorized personnel. ▪ Official pre-numbered purchase orders are used. ▪ Proper approval is required for purchases. ▪ Proper record keeping of orders.
Separation of duties	▪ Separate purchasing and receiving functions. ▪ Separate receiving and storage functions. ▪ Sufficient record-keeping regarding receipt of goods and their use.
Proper and timely recording of transactions	▪ Accounts payable should verify invoices against acquisition requests and purchase orders. ▪ Items, quantity, and prices should be checked. ▪ Liability should be recorded when goods (or invoice) received without delay. ▪ Returns and allowances should be verified against debit memorandum.
Authorization of payments	▪ Proper authority over check signatures ▪ Separation of duties between payment and record keeping. ▪ Verify amount owed against supporting documentation prior to payment. ▪ Physical control (e.g. kept in a safe) of pre-numbered checks.

18-8 The difference in the purpose of the steps is that Procedure 1 ascertains whether all existing acquisitions are recorded properly (completeness and accuracy), whereas Procedure 2 is designed to determine whether recorded acquisitions are proper (occurrence and accuracy). Although the two procedures test opposite objectives (completeness and occurrence), they are similar in that each is designed to determine that the vendor's name, type of material and quantity purchased, and total amount of the acquisition agree with the receiving report, vendor's invoice, and acquisitions journal entries.

18-9 In designing tests of details of accounts receivable balances, the auditor emphasizes potential overstatement of such balances. Auditors verify accounts receivable balances by initialing confirmations and comparing accounts receivables against supporting documentation such as sales receipts, shipping orders, and subsequent cash receipts. Conversely, when designing tests of details of accounts payable balances, the auditor emphasizes potential understatement.

18-10 In order to streamline ordering and purchasing, many businesses electronically link their internal accounting systems to suppliers' systems. By sharing information electronically, suppliers can access inventory records to anticipate an order, or plan their own production schedule, or suppliers can access accounts payable records to monitor the status. When suppliers have access to a company's inventory and payables systems, IT risks increase as well as the risk of material misstatements if IT controls at the supplier are ineffective. Sharing of information through networks or e-commerce systems also exposes sensitive company data as well as software and hardware systems to potential cybersecurity risks.

Companies may also make changes in the way inventory physically moves through the supply or distribution channel. For example, a company may move from purchasing from a centralized warehouse to purchasing from regional distribution centers. Changes in the supply and distribution channels may make it more difficult to track inventory movements, increasing the risk of cutoff errors in inventory and accounts payable.

18-11 A large proportion of expenses incur an accounts payable liability prior to payment, so current period expenses are likely to be closely related to current period changes in accounts payable. Substantive analytical procedures can be used to compare both current period expenses and accounts payable against prior years. Potential accounts payable could relate to rent expense, utilities expense, insurance expense, and other commonly repeated expenses that should not deviate much on a monthly basis.

18-12 The procedure will most likely uncover the misstatement in item b. The search for unrecorded invoices is designed to detect an understatement of accounts payable.

18-13 Unless evidence is discovered that indicates that a different approach should be followed, auditors traditionally follow a conservative approach in selecting vendors for accounts payable confirmations and customers for accounts receivable confirmations. The auditor assumes that the client is more likely to understate accounts payable, and therefore concentrates on the vendors with whom the client deals actively, especially if that vendor's balance appears to be lower than normal on the client's accounts payable listing at the confirmation date. In verifying accounts receivable, the auditor assumes that the client is more likely to overstate account balances, and for that reason concentrates more on the larger dollar balances and is not as concerned with "zero balances."

18-14 There are several reasons why it is not as common to confirm accounts payable at an interim date as it is for accounts receivable:

- Less reliance is placed on accounts payable systems than accounts receivable systems for most audits. For accounts payable, it is common to rely heavily on the search for unrecorded accounts payable to test the balance. When control risk is assessed at the maximum, it is inappropriate to confirm at an interim date.
- In auditing accounts payable, it is common for the auditor to confirm only those accounts for which vendors' statements are not available (received by the client) at year-end. Hence, the auditor will not know which accounts will be confirmed until the end of the year.
- Accounts payable confirmation is usually a less important and less time-consuming task than confirmation of receivables; therefore, it is less important to confirm the accounts payable early for purposes of reducing year-end audit time.

18-15 There are several tests conducted by auditors to confirm details of balances for accounts payable. First, the auditor can examine subsequent cash payments to ensure that payments for liabilities that occur during the current period are accurately reflected. A second, related test is to examine unpaid subsequent accounts payable balances to determine whether the ones that existed during the current period were property recorded as such. Other tests include comparing receiving documents and purchase orders and invoices against recorded accounts payable; verifying accounts payable against vendor statements; and sending confirmations to vendors, especially those with on-going business relationships with the client.

■ Multiple Choice Questions From CPA Examinations

18-16 a. (2) b. (4) c. (4)

18-17 a. (3) b. (3) c. (3) d. (1)

■ Discussion Questions and Problems

18-18

QUESTION	a. TRANSACTION-RELATED AUDIT OBJECTIVE(S)	b. TEST OF CONTROL	c. POTENTIAL MISSTATEMENT(S)	d. SUBSTANTIVE PROCEDURE
1	Recorded acquisitions and payments are for goods and services received, consistent with the best interests of the client (occurrence).	Observe and inquire about personnel performing purchasing, shipping, payables, and disbursing functions.	Goods received and not recorded or recorded and not received. Disbursements made for goods not received.	Vendor statement reconciliation. Review of physical inventory shortages.
2	Existing acquisitions are recorded (completeness).	Account for numerical sequence of receiving reports and determine that all were recorded.	Receiving reports are misplaced and acquisitions not recorded.	Vendor statement reconciliation.
3	Acquisitions are recorded on the correct dates (timing). Existing acquisitions are recorded (completeness).	Observe and inquire about the procedure performed by mail clerk. Compare date mail is received to date accounting received invoices.	Late recording or non-recording of liabilities to suppliers.	Vendor statement reconciliation. Search for unrecorded liabilities.
4	Acquisition transactions are properly classified (classification).	Examine indication of approval.	Acquisitions are recorded in the wrong account.	Examine supporting invoice for reasonablenes s of accounting distribution.