

CHAPTER 15

AUDITING THE EXPENDITURE CYCLE

Learning Check

- 15-1. The expenditure cycle involves the activities associated with the acquisition of and payment for plant assets and goods and services. There are two major classes of transactions in this cycle: (1) purchasing and (2) cash disbursements.
- 15-2. The audit objectives for the expenditure cycle are:

Specific Audit Objectives
Transaction Objectives
Occurrence. Recorded purchase transactions represent goods or services received during the period (EO1). Recorded cash disbursement transactions represent cash received during the period (EO2). Recorded purchase returns represent goods returned during the period (EO3).
Completeness. All purchases (C1), cash disbursements (C2) and purchase returns (C3) made during the period were recorded.
Accuracy. All purchases (VA1), cash disbursements (VA2), and purchase returns (VA3) are accurately valued using GAAP and correctly journalized, summarized and posted.
Cutoff. All purchases (EO1 or C1), cash disbursements (EO2 or C2), purchase returns (EO3 or C3) have been recorded in the correct accounting period.
Classification. All purchases (PD1), cash disbursements (PD2), and purchase returns (PD3) have been recorded in the proper accounts.
Balance Objectives
Existence. Accounts payable represent amounts owed to vendors at the balance sheet date (EO4).
Completeness. Accounts payable includes all payments owing to vendors at the balance sheet date (C4).
Rights and Obligations. Accounts payable are obligations of the entity at the balance sheet date (RO1).
Valuation and Allocation. Accounts payable are correctly stated at the amounts owed (VA4).
Disclosure Objectives
Occurrence and Rights and Obligations. Disclosed purchase cycle events and transactions have occurred and pertain to the entity (PD4).
Completeness. All purchase cycle disclosures that should have been included in the financial statements have been included (PD5).
Classification and Understandability. Purchase cycle information is appropriately presented and described and information in disclosures is clearly expressed (PD6).
Accuracy and Valuation. Purchase cycle information is disclosed accurately and at appropriate amounts (PD7).

- 15-3. The purchases cycle is material to most manufacturing, wholesaling, and retailing organizations. Purchases of inventory are usually material to the financial statements taken as a whole. Costs of manufacturing may be affected by technological change and may not be consistent from one year to the next. When purchases are so high in volume and have such a significant effect on the financial statement, the auditor will want to understand the system of internal control and hopefully plan a lower assessed level of control risk approach.

On the other hand, purchases may be relatively insignificant to a school district. Payroll, rather than expenditures for goods or purchased services, may account for over 85% of operating costs. Recurring costs such as utilities and maintenance are borderline material and these amounts may be quite predictable. In these cases there may be a low inherent risk associated with expenditures and their predictability may allow for an emphasis on analytical procedures. However, the auditor will usually use a primarily substantive approach when searching for unrecorded liabilities.

- 15-4. Materiality is probably going to be a factor because expenditure cycle transactions affect more financial statement accounts than the other cycles combined. For example, the expenditure cycle may affect a number of expense and asset accounts while the revenue cycle primarily affects sales and accounts receivable. Moreover, these transactions affect account balances that normally have a material effect on the balance sheet and income statement. In a few instances with some service organizations, payroll costs (see Chapter 16) are the primary cash outflow and expenditures may be less significant.
- 15-5. a. Management might be motivated to understate payables and related expenses in order to achieve announced profitability targets or industry norms. If management is attempting to smooth earnings, management might attempt to incur expenses in a good year that otherwise might be incurred in subsequent years. Management might also be under pressure to understate payables in order to report improved working capital margins or to meet debt covenants.
- b. Industry factors may impact the trade terms related to accounts payable. Some companies are also able to manage their operating cycle such that they can turn their inventory and collect from customers before they have to pay their suppliers. Some made to order business often collect customer deposits prior to recognizing revenues resulting in a nonmonetary liability for deferred revenues. In some industries that are capital intensive, current liabilities may not be as significant as long-term debt.
- c. A common risk of misstatement in the financial statements is failure to control for duplicate payment of vendor's invoices (the existence and occurrence assertion). The expenditure cycle is also prone to the risk of employee fraud through unauthorized disbursement of cash. The auditor might also be concerned about unauthorized purchases, or the misappropriation of purchased assets. Finally, the auditor should also be concerned about the proper implementation of capitalization policies.
- d. Auditors are primarily concerned about the understatement of liabilities because of the auditor's business risk of being sued associated with the possible overstatement of earnings due to earnings management activities that understate expenses and liabilities.

- 15-6. a. Some common analytical procedures performed in analyzing the risk of misstatement in the expenditure cycle include:

Ratio	Calculation
Accounts Payable Turn Days	$\text{Avg. Accounts Payable} \div \text{Purchases} \times 365$
Cost of Goods Sold to Accounts Payable	$\text{Cost of Goods Sold} \div \text{Accounts Payable}$
Payables as a % of Total Assets	$\text{Accounts Payable} \div \text{Total Assets}$
Current Ratio	$\text{Current Assets} \div \text{Current Liabilities}$
Quick Ratio	$\text{Current Monetary Assets} \div \text{Current Monetary Liabilities}$

- b. Accounts payable turnover is less likely to be manipulated as it includes a measure of activity during the entire period (purchases). Alternatively, ratios such as the current ratio or quick ratio are only snap-shots as of the balance sheet date and may be subject to manipulation through one-time, year-end transactions by management.

- 15.7. Key elements of the control environment that are relevant to initiating and recording purchases:

- A commitment by senior management to integrity and ethical values, particularly as it relates to pressures on purchasing agents who may be offered kickbacks for transacting business with vendors.
- A commitment to competence should be reflected in the hiring, assigning, and training of personnel involved in processing purchases and cash disbursements.
- The assignment of authority should require clear accountability for expenditures and such accountability should be implemented on a timely basis.

15-8. a. Function	b. (1) Department	(2) Document/Record
Authorizing vendors	Stores and other departments	<ul style="list-style-type: none"> • Authorized vendor file
Initiating purchases	Stores or other departments	<ul style="list-style-type: none"> • Purchase requisition
	Purchasing	<ul style="list-style-type: none"> • Purchase order • Open purchase order file
Receiving goods and services	Receiving	<ul style="list-style-type: none"> • Receiving report • Receiving file
	Stores and other departments	<ul style="list-style-type: none"> • Various inventory files
Recording liabilities	Accounting – accounts payable	<ul style="list-style-type: none"> • Vendor's invoice • Voucher • Purchases transaction file and accounts payable master

file.

- Various suspense files

15-9.

	Potential Misstatement	Potential Control	Potential Test of Control
a	Vouchers may not be recorded for goods received.	The computer prepares an exception report of goods received that are not matched with a voucher.	Use CAATs to test the control by submitting data that should be rejected by the control.***
b	Vouchers may be prepared for goods not order or received.	The computer checks for receiving of goods prior to processing a voucher.	Use CAATs to test the control by submitting data that should be rejected by the control.***
c	Goods may be taken from storage areas.	Goods are safeguarded and a perpetual inventory is kept. Physical goods are compared to perpetual records on a regular basis.	Observe safeguarding of inventory. Inspect evidence of comparing inventory on hand with perpetual records.
d	Goods received may not have been ordered.	Receiving must check for authorized purchase order prior to receiving goods.	Observe receiving clerks performing their duties and make inquiries of receiving clerks and others responsible for the warehouse or inventory quantities about the effectiveness of the control
e	Vouchers are recorded in the wrong accounting period.	The computer compares the accounting period on the voucher with the accounting period on the receiving report.	Use CAATs to test the control by submitting data that should be rejected by the control.***
f	Vouchers are recorded in the wrong amount.	The computer compares the quantities on the voucher with quantities on the receiving report and the prices on the voucher with prices on the purchase order.	Use CAATs to test the control by submitting data that should be rejected by the control.***
g	Vouchers are charged to the wrong account.	The computer compares the account number on the voucher with the account number on the purchase order.	Use CAATs to test the control by submitting data that should be rejected by the control.***

*** Tests of computer controls must also test the effectiveness of manual follow-up procedures and computer general controls.

15-10. Usually a company will create an accounts payable master file that lists payables by due dates. Daily an individual with responsibility for treasury functions will check the amounts that come due that day with cash availability and will authorize particular liabilities to be paid. Prior to issuing a check a computer control will ensure that a proper voucher has been recorded. Also, batch totals for amounts authorized and the amount of the check run will also be compared prior to processing. Finally checks will usually be compared with an authorized check list by an independent person.

15-11.

	Control	Potential Misstatement	Test of Control
a	Checks are prenumbered and accounted for.	A check may not be recorded.	Examine evidence of use of and accounting for prenumbered checks
b	Check signer mails the checks.	A check may be altered after being signed.	Inquire about mailing procedures and observe mailing.
c	Computer compares check information with supporting voucher information.	A check may be issued for goods not purchased or received.	Use CAATs to test the control by submitting data that should be rejected by the control.***
d	Run-to-run totals compare beginning cash balances, less cash disbursements, with ending cash balances.	Check may be posted to cash in the wrong amount.	Use CAATs to test the control by submitting data that should be rejected by the control.***
e	Computer performs a limit test on large disbursements, which must be manually signed.	A check may be issued in the wrong amount.	Use CAATs to test the control by submitting data that should be rejected by the control.***
f	An appropriate level of management monitors cash daily, including the amount of checks written daily, the reasonableness of such amounts, and the amount of debits to accounts payable daily.	Checks may be recorded in the wrong amount or may not be correctly posted to accounts payable.	Inspect documents showing evidence of monitoring cash and comparing cash disbursements with debits to accounts payable. Make inquiries about the performance of monitoring procedures.

*** Tests of computer controls must also test the effectiveness of manual follow-up procedures and computer general controls.

- 15-12. a. The economic substance of purchase adjustments involves returning goods to vendors. These may be defective goods or goods that were substituted for goods that were initially ordered. Vendors may also offer price concessions for various reasons and including offering to pay for holding costs on slow moving goods. Each of these transactions results in reducing payables and expenses, improving reported liquidity and earnings. Sound financial reporting needs to establish adequate controls over these transactions to prevent their abuse in earnings management activities.
- b. Sound internal controls over purchase adjustments should focus on
- All purchase returns should be authorized by the vendor (EO3).
 - Goods should be accepted for return only with a proper purchase return authorization, and an independent count of goods returned should be recorded on shipping documents such as packing slips and bills of lading (EO3).
 - The computer should match of debit memo information with the authorization for purchase return and the shipping documents (EO3, VA3).
- The common focus of these controls is the occurrence of purchase returns. Remember, problems with the existence of purchase returns (they reduce accounts

payable) can result in understating accounts payable (completeness problems for accounts payable).

- 15-13. a. The primary account balance in the expenditure cycle is accounts payable. If good controls exist over purchases, cash disbursements, and purchase adjustments, accounts payable should also be controlled, as it is the product of recording these transactions.
- b. Most companies control the completeness (C4), existence (EO4) and valuation of receivables at historical cost (VA4) by reconciling the accounts payable subsidiary ledgers with vendor statements.
- c. Controls over the rights and obligations assertion relate to whether the payables are the obligation of the entity. This is usually controlled when the liability is recorded by matching the voucher information with supporting data (RO1).
- d. Public companies normally accomplish controls over disclosure through the workings of a disclosure committee that is independent of the CFO or controller who prepares the disclosures. The committee should include individuals who are knowledgeable about GAAP the transactions and disclosures relevant to the expenditure cycle.

15-14. The following table provides example controls and tests of controls for each assertion (and transaction level audit objective) related to purchases and cash disbursements. Examples emphasize programmed control procedures where appropriate. Student should note that tests of controls should also emphasize testing computer general controls, observing exception reports, and testing manual follow-up of items that appear on exception reports.

Purchases

Assertion (Audit Objective)	Control	Test of Controls
Existence and Occurrence (Occurrence)	The computer checks for receiving of goods prior to processing a voucher.	Use CAATs to test the control by submitting data that should be rejected by the control.
Completeness (Completeness)	The computer prepares an exception report of goods received that are not matched with a voucher.	Use CAATs to test the control by submitting data that should be rejected by the control.
Existence and Occurrence / Completeness (Cutoff)	The computer compares the accounting period on the voucher with the accounting period on the receiving report.	Use CAATs to test the control by submitting data that should be rejected by the control.
Valuation and Allocation (Accuracy)	The computer compares the quantities on the voucher with quantities on the receiving report and the prices on the voucher with prices on the purchase order.	Use CAATs to test the control by submitting data that should be rejected by the control.
Presentation and Disclosure (Classification)	The computer compares the account number on the voucher with the account number on the purchase order.	Use CAATs to test the control by submitting data that should be rejected by the control.
Rights and Obligations	Rights and obligations is usually	Use CAATs to test the control by

	controlled when the liability is recorded by matching the voucher information with supporting data.	submitting data that should be rejected by the control.
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Cash Disbursements

Assertion (Audit Objective)	Control	Test of Controls
Existence and Occurrence (Occurrence)	Computer compares check information with supporting voucher information.	Use CAATs to test the control by submitting data that should be rejected by the control.
Completeness (Completeness)	The computer compares the total on the check summary with the total vouchers submitted for payment.	Use CAATs to test the control by submitting data that should be rejected by the control.
Existence and Occurrence / Completeness (Cutoff)	An independent bank reconciliation is performed.	Observe and test the accuracy of independent bank reconciliations.
Valuation and Allocation (Accuracy)	Computer compares check information with supporting voucher information.	Use CAATs to test the control by submitting data that should be rejected by the control.
Presentation and Disclosure (Classification)	Computer compares vendor and account information with purchase order.	Use CAATs to test the control by submitting data that should be rejected by the control.
Rights and Obligations	Rights and obligations is usually controlled when the liability is recorded by matching the voucher information with supporting data. At the cash disbursements stage the computer compares check information with supporting voucher information.	Use CAATs to test the control by submitting data that should be rejected by the control.

- 15-15. a. The completeness assertion is of primary importance to the auditor in auditing accounts payable because of the risk of possible understatement of the balance.
- b. The existence or occurrence assertion for cash disbursements transactions and the completeness assertion for purchases transactions relate to the completeness assertion for accounts payable.
- 15-16. a. The substantive tests that pertain to the completeness assertion are:
1. Perform analytical procedures.
 2. Vouch a sample of recorded accounts payable transactions to supporting documentation.
 3. Perform purchases cutoff test
 4. Perform cash disbursements cutoff test.
 5. Perform search for unrecorded liabilities.
 6. Confirm accounts payable
 7. Reconcile unconfirmed payables to monthly statements received by client from vendors.

- b. The other assertions to which each test relates are
 - Existence or occurrence - all tests except 5
 - Rights and obligations - (2), (6), and (7)
 - Valuation or allocation - (1),(2),(6), and (7)
 - Presentation and disclosure - (2), (6), and (7)
- 15-17. Disagree. Unlike the presumption that accounts receivable will be confirmed with limited exceptions, there is no such presumption about the confirmation of accounts payable. This test is optional because (a) confirmation offers no assurance that unrecorded payables will be discovered, and (b) external evidence in the form of invoices and vendor monthly statements should be available to substantiate the balances. Confirmation of accounts payable is recommended when control risk is high, there are individual creditors with relatively large balances, and when a company is experiencing difficulties in meeting its obligations.
- 15-18.a. 1. The purchases cutoff test involves (a) selecting a sample of recorded purchase transactions from several days before and after year-end and examining supporting vouchers, vendor invoices, and receiving reports to determine that the purchases were recorded in the proper period, or (b) observing the number of the last receiving report issued on the last business day of the audit period and tracing a sample of lower and higher numbered receiving reports to related purchase documents and determining that the transactions were recorded in the proper period. This test would also be performed during a five-to-seven day period before and after the balance sheet date.
2. The cash disbursements cutoff test is performed by (a) observing the number of the last check issued and mailed on the last day of the audit period and tracing it to accounting records to verify the accuracy of the cutoff, or (b) tracing dates on "paid" checks returned with year-end and cutoff bank statements to dates the checks were recorded.
- b. Both tests provide evidence for the existence or occurrence and completeness assertions for accounts payable.
- 15-19. a. In vouching recorded payables to supporting documentation, recorded entries in creditor accounts or in the voucher register are vouched to vendor invoices, vouchers, and creditor monthly statements. This test relates to all five categories of assertions.
- b. In examining subsequent payments, payments after the balance sheet date are vouched to supporting documentation, and if an obligation is found to have been in existence at year-end, it is traced to the accounts payable listing. This is an important test for the completeness assertion.

- c. In determining whether payables are properly identified and classified, the auditor is concerned with the type of payable (such as whether payable to a vendor, employee, or related party), and the expected period of payment (e.g., whether current or noncurrent). This test relates to the presentation and disclosure assertion.

15-20. Some examples of other assurance services that an auditor might consider include:

- Recommendations on how to improve cash flow and best-in-class activities associated with payment of accounts payables.
- Recommendations on the economic consequences of potential contracts on cash flows and payables.

Comprehensive Questions

15-21. (Estimated time - 15 minutes)

Purchases and accounts payable are material transactions for an independent grocer. An independent grocer probably does not purchase directly from manufacturers and will not have a significant investment in the supply chain the way a major grocery chain will, but it will have a network of vendors that supply goods. The auditor will need to understand these vendor relations and how goods are ordered and priced. Significant inherent risks associated with an independent grocer include:

- Concerns about accounting for advertising allowances and other price concessions to stock merchandise on grocery shelves.
- Concerns about purchases cutoff at month-end.
- Concerns about potential unrecorded liabilities.

15-22. (Estimated time - 15 minutes)

The concurrent decline in inventory turn days and gross margins gives rise to a concern about inventory shrinkage. It is possible that inventory that is purchased from vendors is not being sold to customers, but is subject to employee theft. This would explain what appears to be a faster turn of inventory, combined with the lower margins (no sales prices associated with inventory reductions).

15-23. (Estimated time - 25 minutes)

- a The following table provides the solutions to the quantitative requirements of 15-23.

	Year 5	Year 4	Year 3	Year 2	Year 1
	<u>Unaudited</u>	<u>Audited</u>	<u>Audited</u>	<u>Audited</u>	<u>Audited</u>
Inventory	\$ 525,000	\$ 460,000	\$ 390,000	\$ 310,000	\$ 225,000
Current Assets	\$ 1,350,000	\$ 1,175,000	\$ 950,000	\$ 750,000	\$ 600,000
Accounts Payable	\$ 115,000	\$ 113,000	\$ 97,500	\$ 850,000	\$ 70,000
Current Liabilities	\$ 545,000	\$ 535,000	\$ 440,000	\$ 380,000	\$ 320,000
Sales	\$ 2,700,000	\$ 2,050,000	\$ 1,750,000	\$ 1,400,000	\$ 1,200,000
Cost of Goods Sold	\$ 1,650,000	\$ 1,225,000	\$ 1,025,000	\$ 850,000	\$ 725,000
Industry Median					
Accounts Payable Turn Days	31	30	29	30	
Cost of Goods Sold to Accounts Payable	10.7	11.2	10.9	11.1	
Current Asset to Current Liabilities	1.9	2.2	2.3	2.1	
Purchases	\$ 1,715,000	\$ 1,295,000	\$ 1,105,000	\$ 935,000	
Accounts Payable Turn Days	24.5	31.8	32.2	331.8	
Cost of Goods Sold to Accounts Payable	14.3	10.8	10.5	1.0	
Current Ratio	2.48	2.20	2.16	1.97	

- b. The decrease in account payable turn days, the increases in the ratio of costs of goods sold to accounts payable and the current ratio indicate a potential for unrecorded liabilities and the understatement of accounts payable. As a result the audit team needs to pay significant attention to the completeness assertion for accounts payable. Given the results of analytical procedures the audit team should consider a primarily substantive approach emphasizing tests of details when performing a search for unrecorded liabilities.

15-24. (Estimated time - 20 minutes)

STAR MANUFACTURING, INC.

Purchases

Internal Control Questionnaire

Purchase order and receiving segments

1. Are there written purchasing policies and procedures?
2. Are purchase requisitions approved in accordance with management's authorization?
3. Are purchases made from approved vendors?
4. Are price quotations requested for purchases over an established amount?
5. Are purchase commitments documented on written purchase order forms?
6. Do purchase orders include adequate descriptions, terms, and instructions?
7. Are purchase orders approved by authorized personnel before issuance?
8. Are prenumbered purchase order forms periodically accounted for?

9. Is a detailed listing of purchase orders maintained?
10. Is the purchasing function independent of receiving, shipping, invoice processing, and treasury functions?
11. Are there adequate safeguards over unissued purchase order forms?
12. Are old items in the open purchase order file periodically investigated?
13. Are vendors notified of conflict of interest policies?
14. Is an approved purchase order required for all goods received from vendors?
15. Are quantities obliterated on copies of purchase orders sent to receiving?
16. Are prenumbered receiving reports prepared?
17. Is a signed receipt obtained from the storeroom or other requisitioning department on delivery of goods by receiving?

15-25. (Estimated time - 20 minutes)

- a. The adequacy of internal control is questionable whenever quantities are not blocked out on the copy of the purchase order which is sent to the receiving department because this practice may cause the receiving clerk to bypass the counting and inspection procedures. The receiving clerk may only compare the purchase order and packing slip (or other document accompanying the shipment) and prepare a receiving report based upon these documents. As a result of this weakness, merchandise which is incorrect with respect to quantity or unacceptable with respect to quality may be receive and accepted. However, in the case of Dunbar Manufacturing, Inc., in certain areas there are compensating controls.
 - *Receipt of sheetmetal*.—Although the receiving clerk may only compare quantities on the purchase order and the bill of lading, there is a compensating control over quantities of sheetmetal received. This is because the bill of lading provides independent verification of weights received and date of receipt. However, sheetmetal with unacceptable quality specifications may be received and accepted.
 - *Receipt of screws*: Since the receiving clerk weighs the screws upon receipt, and since the weight is converted to units, control over quantities received is adequate. Furthermore, screws of an unacceptable specification may be expected to be detected during the weighing and inspecting process.
 - *Receipt of camera lenses*: Because there are no controls which compensate for the weakness with respect to the receipt of camera lenses, there is inadequate control over the quantity and quality of lenses received.
- b. Inventory may be overstated and the cost of merchandise sold and income may be misstated because additions to inventory may be based on suppliers' invoices which may include nonusable items or items that were not received. Further, because the company may have erroneously recorded nonusable items or items not received, accounts payable may be overstated.

15-26. (Estimated time - 30 minutes)

XY Company's major internal control weaknesses are:

Purchasing:

- The buyer does not verify that the department head's request is within budget limitations.
- No procedures have been established to assure that the best price is obtained. Large dollar requisitions should be ordered after receiving quotes and/or sealed bids.
- Prior to placing an order, the buyer does not determine the adequacy of the vendor's past record as a supplier to XY.

Receiving:

- Receiving clerk does not make blind counts for all special equipment or at least for large dollar items.
- Written notice of equipment received is not sent to purchasing.
- Written notice of equipment received is not sent to accounts payable.

Accounts Payable:

- The mathematical accuracy of the invoice is not recomputed.
- Invoice quantity is not compared with a report of quantity received.
- Notification of the acceptability of the equipment from the requisitioning department is not obtained before the payable is recorded.
- No alphabetic file of vendors from whom purchases are made is maintained.

Treasurer:

- Documentation supporting the checks is not sent by the accounts payable department to the cashier in order for the cashier or treasurer to be assured that the check is for properly authorized and received equipment.
- Checks for large dollar purchases are not signed by two officers of XY company to assure that material expenditures are proper.
- All documentation to support a check is not canceled by the check-signer and returned to the accounts payable department.
- The cashier alone has custody of the key, the signature plate, and record of usage.
- The controller is authorized to sign checks.

15-26. (Estimated Time – 30 Minutes)

**Consistent /
Inconsistent**

Strengthen or Weaken

- | | |
|-----------------|--|
| 1. Consistent | Purchase requisitions provide the authorization for purchasing to place an order. (Given as an example.) |
| 2. Consistent | The use of prenumbered purchase order forms provides a control over purchase commitments. |
| 3. Inconsistent | The copy of the purchase order forwarded to receiving should have the quantity order blanked out. Knowledge of the quantity ordered might bias the receiving department's count of items received. |
| 4. Inconsistent | The receiving department should count and inspect the goods received, not simply make a notation that the order was received. |
| 5. Consistent | The matching of purchase order, receiving report, and vendor invoice assures that an order was placed, the shipment was received, and the vendor has a proper claim. |
| 6. Consistent | Proving the mathematical accuracy of the vendor invoice assures that the billing is correct. |
| 7. Inconsistent | The plant controller is responsible for record keeping and should not have the responsibility of authorizing disbursement vouchers. Incompatible duties are vested in the plant controller. |
| 8. Inconsistent | Corporate headquarters received the approved disbursement voucher which was approved by the plant controller. All the supporting documentation supporting the validity of the transaction and obligation are filed at the plant. |
| 9. Inconsistent | The check issue list should be reconciled with the submitted disbursement before being filed. |

15-28. (Estimated time - 25 minutes)

- a. The accounts payable audit procedures should be directed toward searching for proper inclusion of all accounts payable and ascertaining that recorded amounts are reasonably stated because the primary audit purpose is to reveal any possible material understatements.

The principal specific audit objectives for accounts payable are:

- Recorded accounts payable represent amounts owed by the entity at the balance sheet date (existence or occurrence).
- Accounts payable includes all amounts owed by the entity to suppliers of goods and services at the balance sheet date (completeness)
- Accounts payable are obligations of the entity at the balance sheet date (rights and obligations)
- Accounts payable are stated at the correct amount owed (valuation or allocation).
- Accounts payable are properly identified and classified in the financial statements and disclosures pertaining to commitments, contingent liabilities,

and collateralized and related party payables are adequate (presentation and disclosure).

- b. Mincin is not required to use accounts payable confirmation procedures. For accounts payable the auditor can examine external evidence such as vendor invoices and vendor statements which substantiate the accounts payable balance. Although not required, the accounts payable confirmation is often used. The auditor might consider such use when:
- Internal controls are weak (detection risk is low).
 - The company is in a "tight" cash position and bill paying is slow.
 - Physical inventories exceed general ledger inventory balances by significant amounts.
 - Certain vendors do not send statements.
 - Vendor accounts are pledged by assets.
 - Vendor accounts include unusual transactions.
- c. A selection technique using the large dollar balances of accounts is generally used when the primary audit objective is to test for overstatements (e.g., accounts receivable audit work). Accounts with zero balances or relatively small balances would not be subjected to selection under such an approach. When auditing accounts payable, the auditor is primarily concerned with the possibility of unrecorded payables or understatement of recorded payables. Selection of vendor accounts with relatively small or no balances for confirmation is the more efficient direction of testing since understatements are more likely to be detected when examining such accounts.

When selecting accounts payable for confirmation the following procedures could be followed:

- Analyze the accounts payable population and stratify it into accounts with large balances, accounts with small balances, accounts with zero balances, etc.
- Use a sampling technique that selects items based on criteria other than the dollar amount of the item (e.g., select based on terminal digits, select every nth item based on predetermined interval, etc.).
- Design a statistical sampling plan that will place more emphasis on selecting accounts with zero balances or relatively small balances, particularly when the client has had substantial transactions with such vendors during the year.
- Select prior-year vendors who are no longer used.
- Select new vendors used in the subsequent period.
- Select vendors that do not provide periodic statements.
- Select accounts reflecting unusual transactions during the year.
- Select accounts secured by pledged assets.

15-29. (Estimated Time – 30 Minutes)

- a. The fact that the client made a journal entry to record vendors' invoices which were received late should simplify the CPA's test for unrecorded liabilities and reduce the possibility of a need for a further adjustment, but the CPA's test is nevertheless required. Clients normally are expected to make necessary adjustments to their books so that the CPA may examine statements which the client believes are complete and correct. If the client has not journalized late invoices, the CPA is compelled in his testing to substantiate what will ultimately be recorded as an adjusting entry. In this examination the CPA should test entries in the 19X1 voucher register to ascertain that all items which according to date of receiving reports or vendors' invoices were applicable to 19X0 have been included in the journal entry recorded by the client.
- b. No. The CPA should obtain a letter in which responsible executives of the client's organization represent that to the best of their knowledge all liabilities have been recognized. However, this is done as a normal audit procedure to afford additional assurance to the CPA and it does not relieve him of the responsibility for making his own tests.
- c. Whenever a CPA is justified in relying on work done by an internal auditor, he should curtail (but not eliminate) his own audit work. In this case the CPA should have ascertained early in his examination that Ozine's internal auditor is qualified by being both technically competent and reasonably independent. Once satisfied as to these points, the CPA should discuss the nature and scope of the internal audit program with the internal auditor and review his working papers in order that the CPA may properly coordinate his own program with that of the internal auditor. If the Ozine internal auditor is qualified and has made tests for unrecorded liabilities, the CPA may limit his work to a brief test in this audit area.
- d. Work done by an auditor for a federal agency will normally have no effect on the scope of the CPA's audit, since the concern of government auditors is usually limited to matters which are unrelated to the financial statements. Nevertheless the CPA should discuss the government auditor's work program with him, as there are isolated situations where specific procedures followed to a satisfactory conclusion by a government auditor will furnish the CPA with added assurance and therefore permit him to curtail certain work in a particular area. However, government auditors are usually interested primarily in substantiating as valid and allowable those costs which a company has allocated against specific government contracts or sales to the government, and consequently there is little likelihood that the auditor for a federal agency at Ozine would check for unrecorded liabilities.
- e. In addition to the 19X1 voucher register, the CPA should consider the following sources for possible unrecorded liabilities:

- Unentered vendors' invoice file.
- Status of tax returns for prior years still open.
- Discussions with employees.
- Representations from management.
- Comparison of account balances with preceding year.
- Examination of individual accounts during the audit.
- Existing contracts and agreements.
- Minutes.
- Attorney's bills and letter of representation.
- Status of renegotiable business.
- Correspondence with principal suppliers.
- Audit testing of cutoff date for reciprocal accounts, e.g., inventory and fixed assets.

15-30. (Estimated time - 20 minutes)

Taylor should perform the following additional substantive tests.

- Foot the client-prepared schedule.
- Tie the general ledger accounts payable control account to the client-prepared accounts payable schedule.
- Examine vendors' statements in support of items on the client-prepared schedule.
- Examine other documents (such as approved vouchers) in support of items on the client prepared schedule.
- Review the general ledger control account for noncash debits or unusual items, and investigate them.
- Confirm, with positive confirmation requests, account balances from vendors with account balances and vendors with zero account balances.
- Examine unpaid invoices on hand (to ascertain whether any were erroneously omitted from the client-prepared schedule of accounts payable).
- Examine documents in support of invoices paid subsequent to the year end (to ascertain whether the payable was recorded in the appropriate year).
- Inspect receiving reports (to test the accuracy of the year-end cutoff).
- Ascertain whether year-end outstanding checks to vendors were returned with the cutoff bank statement.
- Review correspondence files with respect to disputed items.
- Review open purchase orders for unusual or old items that may have been received but not recorded.
- Examine unmatched receiving reports.
- Make certain that the client representation letter includes the proper assertions concerning accounts payable.
- Investigate and resolve confirmation exceptions and other matters requiring follow-up.

Cases

15-31. (Estimated Time: 2 hours)

Phase I

This case allows the professor to explore the challenges of auditing privately held companies. While privately held companies do not receive the same attention of public companies, they represent a significant portion of audits performed by CPAs. This case allows students to explore the control environment issues associated with owner-manager companies, typical challenges associated with segregation of duties, and the challenges associated with the implementation of electronic data interchange (EDI) in the owner-managed company environment. Finally, this case also explores issues associated with the potential for misappropriation of assets that is increasingly common in owner-managed companies.

Question 1: Control Environment Issues

The control environment at CIRI is representative of that in a number of owner-managed businesses. The following issues all represent control environment weaknesses.

- Les Browning owns a majority of the business and is focused on growing sales and profits. Les has focused attention on customer relations and then on growing revenues in the lumber brokerage business. His emphasis on marketing and operations has resulted in neglecting accountability and financial reporting.
- Les Browning has delegated oversight of accounting issues and internal controls to his controller, who is not a CPA, and Les is price conscious about salaries and costs of overhead issues such as accounting.
- Tangible evidence of the lack of attention paid to the accounting system is that Les is satisfied with having a balance sheet and income statement on a monthly basis with a lag time of 15-20 days after month-end (Note that management uses neither cash flow projections nor a statement of cash flows on a regular basis.).
- Further evidence of the lack of control environment is the fact that the company has not developed budgets and accountability at the store level for financial results is informal. Senior management's philosophy and operating style has focused on the top line and had not attended to the details of day-to-day expenditures.
- Les Browning has delegated responsibility for the accounting system to Craig Ferris, but there is no significant accountability for results in place. Craig Ferris has delegated the implementation of the EDI system to Dennis Brewer, again with no formal accountability for implementation.

This is also a good time to discuss the implications of a weak control environment on audit strategy. Even if control activities were present there is a reduced likelihood that controls will be operating effectively. Hence, the auditor will probably follow a primarily substantive approach for all significant assertions in material account balances and transaction classes.

Question 2: Analytical Procedures.

The symptoms of decreasing inventory turn days and the decline in gross margins are consistent with the problems of inventory shrinkage. The decrease in inventory turn days shows that there is an increased volume of cost of sales relative to inventory. If margins drop at the same time, one possible scenario is that inventory is going out the door and the company is not collecting from customers for that inventory.

Question 3: Risk Assessment

Background: The auditor should consider the risk of fraud at the financial statement level in every audit. Further, recent Statements on Auditing Standards make it clear that an auditor of a smaller business should not merely default to a primarily substantive approach without considering the factors that influence the risk of material misstatement. A small entity may use sophisticated applications of IT in its information systems. In such circumstance the auditor may need to perform more extensive audit procedures to obtain an understanding of the entity and its environment sufficient to identify and assess risks of material misstatement of the financial statements.

Finally, faculty may want to open a discussion of the challenges of auditing EDI systems that leave no documentary audit trail. Following are some of the more prevalent risks of EDI systems:

- Accuracy of data – increased or unauthorized access to the company's system and programmed data could enable a user to manipulate the company or supplier's transactions. Additionally, the company may rely heavily on programmed data and therefore the programming must be tested and reviewed for errors and timeliness as it can affect production cycles, delivery timing, margins, and other factors.
- Segregation of duties – control may be placed with a reduced number of individuals in the company therefore reducing the internal control over transactions.
- Systems of other parties involved – the information system of the other party involved in electronic transactions must also be questioned as weaknesses in their controls can still expose a company with strong controls to risks of misstatement.
- Corrupt system – an EDI application that has been corrupted could expose the business to inaccurate transactions leading to losses to the business, customers, and/or suppliers. This could translate not only into immediate losses in individual transactions, but also loss of consumer confidence, legal issues, and business decisions made based on inaccurate data.
- Disclosure of confidential information to external parties – a breach of the company's network through unauthorized access could disseminate confidential information.
- Emergencies and system failures – when relying predominately on the system for business operations, the company should have good back up and recovery procedures in the event of a system failure.

Although an EDI environment poses many challenges, it also contributes significant audit advantages. Some of those include:

- Accounts such as receivables, payables, and inventory should be reduced at year-end compared to a non-EDI environment, due to the increased speed of transaction processing from initiation of a transaction through providing consideration for the transaction.
- Computer systems, including EDI, offer an increased consistency of processing of recurring transactions.

- The transition to an EDI system may result in strengthened information technology (IT) controls if the transition is well thought out, designed and tested.

The client's use of EDI might influence the audit approach in the following ways.

When accepting an engagement and planning an audit, the auditors should consider the following initial points:

- The auditor must be well informed about the business and industry and have developed strong expectations for a company's financial data.
- Due to the lack of a paper trail, a controls based audit approach is likely more efficient than a substantive approach. Increasing the level of understanding of the client's system that often goes with planning to perform tests of controls will help the auditor assess the risk of material misstatement in a system that does not offer a significant paper trail. The auditor will usually want to understand and test the following controls in an EDI system.
 - Authentication of transactions
 - Encryption of data
 - Security of system
 - Back up and recovery procedures
 - Documentation of application or procedural changes
- Computer assisted audit techniques (CAATs) should be considered since the auditor could obtain significant coverage of data in an efficient manner. If an audit firm is concerned about the CAATs skills demonstrated by the firm's auditors it should question whether to retain a client who is using EDI for transactions that will have a material impact on the financial statement assertions.
- The auditor might also consider using IT based tests such as integrated test facilities or embedded audit modules. These options should be considered at the time a system is designed, as it is difficult to implement after a system is complete and operating.
 - Integrated test facility – an entire set of fictitious data is input to the system in order to test the controls and output.
 - Embedded audit module – this option provides continual audit procedures since the audit tests are built into the application.

Question 3: Risk Assessment (continued)

Assertion	Fraud Risk Factors			Control Activities	Possible Misstatements
	Incentives / Pressures	Opportunity	Attitude & Rationalization		
Existence and occurrence of purchases and payables	Dennis is seeking advancement, status, and the increased compensation that would come with promotion. Also, add some financial pressures from having children in private schools.	Dennis Brewer has full access to the system, he can initiate purchases, direct drop shipments to delivery locations, record payables, and initiate payments.	Dennis is frustrated with the failure to received a pay increase or promotion based on his efforts. He further believes that he is not earning what he deserves, and he feels that management has been tight fisted with rewards.	Control activities do not exist due to poor segregation of duties and Dennis Brewer's system access.	There is a high risk of inventory shrinkage, particularly with respect to drop-shipments. Dennis Brewer controls the ability to order goods, direct drop shipments to delivery locations, record receipt of goods, and initiate payments.

There are a number of control weakness that can be discussed here.

- First, there is inadequate segregation of duties. In addition to the obvious problem with Dennis Brewer in a position to initiate a drop shipment, create a receiving, and record the transaction, there is only one warehouse clerk at each store responsible for receiving and shipping. This creates an additional problem where there is no significant owner-manager oversight.
- Second, there are no budgets. Les Browning and Craig Ferris only informally review the performance of store managers. This creates a situation with little accountability for managers at each store, or for the organization as a whole. If there is little accountability, there is no significant incentive to expect by accurate accounting numbers, as they are not used in any significant way in managing the company.
- Third, the normal controls over IT implementation did not exist. Normally new system design should include user involvement in design, system testing, and user sign off at the end. The case makes no discussion of any systems testing, and it implies that responsibility for implementing the new EDI system as been delegated to Dennis Brewer with virtually no oversight.
- Fourth, the problem associated with the poor segregation of duties in the new system is made worse by the prior year comments and continuing problems associated with adding new customer (or new delivery locations) to the master customer file. As noted above, Dennis Brewer is in a position to have shipments directed to himself.
- Fifth, it is worth emphasizing the importance of discussion of the control weaknesses and communication among audit team. It is entirely possible that similar risks exist in other cycles. Also, the entire audit team needs to be alert to comments heard in the field, such as some of the comments made by Dennis Brewer that provide insights into incentives, motivations, and an attitude that would rationalize behavior. The entire audit team needs to be alert for all aspects of the audit, not just the particular areas assigned to a team member.

Before beginning the discussion of Phase II, that addresses substantive tests of transactions, it might be useful to review the level of documentary evidence that is available to support audit procedures. In this case virtually all evidence is in electronic form. In circumstances where internal controls are good an audit team might include an EDP specialist to test controls. However, due to the lack of segregation of duties, the auditor might consider the use generalized audit software in substantive testing. Would the auditor want to compare electronic purchase orders with electronic invoices from CWS? For example, the auditor might want to determine who authorized transactions and develop an electronic file of transactions authorized by each individual with access to the system for further analysis. Also, how the auditor needs to consider how to validate the receipt of goods at stores or at drop shipment locations when the only record is in machine-readable form? For example, the auditor could use generalized audit software to match purchases, customer billings, and cash receipts for drop shipments.

Question 4:

Following is a sample letter with two internal control recommendations. Faculty and students may also develop other recommendations, but the following letter should provide a basis for class discussion.

Date

To the Board of Directors
Construction Industry Resources, Inc.

In planning and performing our audit of the financial statements of Construction Industry Resources Incorporated for the year ended December 31, 20x5, we considered its internal control in order to determine our audit procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on internal control. However, we noted certain matters involving the internal control and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention related to significant deficiencies in the design or operation of internal controls that, in our judgment, could adversely affect the organization's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements.

Segregation of Duties in the Purchasing Function

Dennis Brewer currently has electronic access to all phases of purchasing transactions in the EDI purchasing system with Contractors Wholesale Supply. Hence, Mr. Brewer is in a position to initiate a transaction, authorize receipt of the transaction, and record a payable that eventually will result in the payment of invoices to Contractors Wholesale Supply. This presents a risk that Mr. Brewer could possibly initiate a purchase, have it drop shipped to almost any location, record the receiving, and the process payment for the goods. Sound segregation of duties segregates the three major functions; (1) authorizing transactions, (2) having custody and responsibility for receipt of goods, and (3) having responsibility for recording transactions. Mr. Brewer's access to the EDI purchasing system with Contractors Wholesale Supply should be limited to functions necessary to accurately record purchases.

Controls over IT implementation

Dennis Brewer had complete responsibility for implementing the new EDI purchases system with Contractors Wholesale Supply. In order to prevent risk associated with unauthorized alteration of programs or data system design and testing should be separate those who have responsibilities in the system. Further, new systems implementation should involve a variety of individuals from each function that is affected by the program. In addition to Mr. Brewer, it would be normal to involve individuals who initiate purchases and individuals responsible for receiving goods in the testing phase of new systems implementation. Someone with senior IT responsibilities should be responsible for reviewing and testing Mr. Brewer's work. Only after representatives of each user function have approved the system should it be placed in operation. The involvement of user departments in system design greatly reduces the risk of programs not meeting the needs of user department and it provides checks and balances over the system design process.

Budgetary controls and accountability

Currently Construction Industry Resources, Inc. does not have a budgetary process where budget are developed for each operating unit and actual results reported by the accounting system are compared with actual. Construction Industry Resources, Inc. has grown to a sufficient size where budgets are cost effective. Developing a system where managers are accountable for reported results encourages a higher level of attention to the accuracy of results reported by the accounting system. We would recommend that Construction Industry Resources, Inc. establish budgets for each store and for the lumber brokerage business. Managers of each responsibility center should then be held accountable for the reasonableness of variations from planned performance. This will likely improve the operating efficiency of each business unit and it will have a secondary benefit of having management review the accuracy of output from the accounting system.

This report is intended solely for the information and use of the Board of Directors of Construction Industry Resources, Incorporated, management and others within the organization and is not intended for any other purposes. We thank you for the opportunity to continue to be of service to you.

Signature.

Phase II

Question 5: Analyzing the Results of Tests of Transactions. A number of issues are raised above. The following notes address issues associated with internal controls and then issues raised by substantive testing.

Internal Control Issues:

- Exception reports are an important part of the audit trail. They are generated daily, and various transactions may appear on the reports and then clear themselves. In this case they may have provided evidence of drop shipments that had billings from BCWSC that had no matching receiving reports. Dennis could clear these exceptions and throw away the evidence. If all reports were maintained, and not just Wednesday's and Thursday's reports, then a true audit trail is available for the auditor.

Exceptions noted in substantive test:

- The first exception represents a potential valuation problem associated with a transposition problem. CIRI ordered merchandise at one price (\$167 per unit), yet it paid another price (\$176 per unit). The difference for the transaction was \$900 (100 units at \$9 per unit). If the auditor assumes that other items in the strata contain a proportionate number of misstatements relative to the misstatements found in the sample, this results in projected misstatements in the strata of \$50,694. The auditor then needs to determine if the \$50,694 is sufficiently material to come forward to a possible adjustment summary to be aggregated with other possible misstatements. The auditor might consider whether to take an additional sample to ascertain the degree to which such misstatements appear in other transactions and then evaluate the results of a larger sample.
- The second issue forces students to confront some of the realities of inventory counts in small business. In this case goods are received during the inventory count. Eventually they are included in inventory and they are also included in purchases. The purchases are

recorded in the same period in which the goods were received so there the financial statements are presented fairly with respect to this transaction.

- The issue associated with the one drop shipment that was not billed to a customer is very significant. The failure to bill customers is possibly evidence of inventory shrinkage, which could be a serious problem – particularly given the results of analytical procedures. This may be a good place to discuss how students would look at an item that is individually immaterial. Auditors need to consider both quantitative and qualitative issues when they evaluate known audit problems. Quantitatively, if this failure to bill a customer for the drop shipment is projected on the balance of the strata, the auditor's estimate is that \$308,997 of goods at cost have not been billed to customers. Assuming a prior year's gross margin of 19.1% this represents approximately \$368,000 of lost revenues. Qualitatively this audit evidence is the tip of the iceberg and students need to recognize that this is sufficient evidence to ask the auditor to look at more drop shipments for similar problems. When the auditor considers this problem together with the risks associated with Dennis Brewer having unlimited access to the EDI system and the fact that he has incentives and the opportunity to possible order goods and have them shipped to himself, the qualitative aspects of this evidence demands that the auditor bring these issues to management and discuss the need to extend the scope of the audit. The auditor might want to consider using generalized audit software to match EDI shipments with customer billings, to better determine the scope of the problem.

Exhibit 3: Projection of Misstatements on EDI Population									Projected
			# of Trx	n	BV n		AV n	Ratio	Misstatement
Purchases through the EDI System	\$ 16,371,095	100%	3,128		\$ 268,985	100%	\$ 263,762	\$ 16,011,404	\$ 359,691
Drop Shipments	\$ 5,756,077	35%	1,391	11	\$ 80,530	30%	\$ 76,207	\$ 5,447,080	\$ 308,997
Shipped to Stores	\$ 10,615,018	65%	1,737	19	\$ 188,455	70%	\$ 187,555	\$ 10,564,324	\$ 50,694

Question 6: Client Discussions.

An important part of auditing is discussing difficult issues with management. In this case management has not fostered a strong control environment. The weak control environment has led to further problems associated with the possible misappropriation of assets. At this point the auditor has two suspect transactions. The audit team may do further sampling to identify additional suspect transactions, but one of the issues that needs to be raised with management is the beginning of a fraud audit, which is substantially larger in scope than an audit in accordance with generally accepted auditing standards.

The auditor should raise issues with the owner, Les Browning and the controller, Craig Ferris. The auditor should also make it clear that these issue need to be discussed with other absentee owners, even though Les Browning owns 70% of the business. The auditor should come prepared with evidence from the audit and an estimate of the implications of that evidence. The auditor should also take the opportunity to make the point that the cost of implementing better controls might have prevented the potential losses experienced by the company. Finally, the auditor should refer to issues raised in prior (an current) management letters that address the risks that allowed a trusted employee to steal a material amount of inventory by ordering goods through the EDI system, that are shipped to him at any possible location, and then have the Company pay for the goods.

Professional Simulation

	Analytical Procedures		
Situation		Internal Controls	Audit Procedures

To: Audit File
Re: Analytical procedures
From: CPA Candidate

Ratio	Unaudited Ratio	Auditor's Expectation Range
Accounts Payable Turn Days	27 days	32 days – 38 days
Inventory Turn Days	55 days	58 days – 64 days
Gross Margin	48%	42% - 46%
Sales and Accounts Payable Growth Rates	Sales Growth: 7% Accounts Payable Growth: 4%	Sales Growth: 6% - 9% Accounts Payable Growth: 6% - 9%

The above analytical procedures show that accounts payable turn days are significantly below expectations, accounts payable are not growing as fast as expected, inventory turn days are below the auditor's expectation, and gross margins exceed the auditor's expectation. In combination it is likely that there are unrecorded purchases of inventory. The auditor should follow a primarily substantive approach when performing a search for unrecorded liabilities, with a particular focus on unrecorded inventories.

		Internal Controls	
Situation	Analytical Procedures		Audit Procedures

Assertion

- A. Existence and Occurrence
- B. Completeness
- C. Rights and Obligations
- D. Valuation and Allocation
- E. Presentation and Disclosure

	<u>Internal Control</u>	(A)	(B)	(C)	(D)	(E)
1. The computer matches the customer number on the voucher with the customer number on the master customer file.		<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>
2. Only the controller and the assistant controller have the authority to add a new vendor to the vendor master file.		<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
3. The computer checks batch totals and run-to-run totals to ensure that all transactions are processed.		<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>
4. The manager of engine production reviews all purchases charged to his responsibility center on a weekly basis, reviewing vendors, amounts, and account charged.		<input checked="" type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input checked="" type="radio"/>
5. The computer matches the date on the receiving report with the accounting period when the voucher is recorded.		<input checked="" type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
6. The computer prints a report of all purchase orders that have not been received and receivings that have not resulted in the recording of a voucher.		<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

			Audit Procedures
Situation	Analytical Procedures	Internal Controls	

Audit procedure

- A. Vouch accounts payable credits to supporting vouchers, vendor invoices, receiving reports, and purchase orders and other supporting information.
- B. Obtain an understanding of the business and industry and determine the significance of purchases and accounts payable to the entity.
- C. Inquire of management about existence of undisclosed commitments or contingent liabilities.
- D. Trace a sample of cash receipts transactions from cash receipts journal to the general ledger.
- E. Vouch debit memos to underlying shipping reports and vendor's authorizations.
- F. Obtain listing of accounts payable at balance sheet date and determine that it accurately represents the underlying accounting records by footing the listing and determining agreement with (1) the total of the unpaid voucher file, subsidiary ledger, or accounts payable master file, and (2) the general ledger control account balance.
- G. Observe the number of the last receiving report issued on the last business day of the audit period and trace sample of lower and higher numbered receiving reports to related purchase documents and determine that transactions were recorded in the proper period.
- H. Trace dates of "paid" checks returned with year-end cut-off bank statements to dates recorded.
- I. Determine that payables are properly identified and classified as to type and expected period of payment.
- J. Examine subsequent payments between balance sheet date and end of field work, and when related documentation indicates payment was for obligation in existence at balance sheet date, trace to accounts payable listing.

Determine the audit procedure that best addresses the following risks.

<u>Risk</u>	(A)	(B)	(C)	(D)	(E)
	(F)	(G)	(H)	(I)	(J)
Recorded purchases may not represent goods received during the year.	●	○	○	○	○
Cash disbursements may not be recorded in the proper time period.	○	○	○	○	○
All purchases (and payables) during the period may not be recorded.	○	○	●	○	○
Accounts payable might be understated due to the recording of invalid purchase returns.	○	○	○	○	●
The auditor may not have complete information about individual accounts payable that make up the general ledger balance.	○	○	○	○	○
	○	○	○	○	○
	●	○	○	○	○