Chapter 15–Auditing the Expenditure Cycle

Expenditure cycle–consists of activities related to the acquisition of and payment for plant assets and goods and services. Two major transaction classes:

> 1–purchases transactions
> 2-cash disbursements

For our purposes here, it does not involve payroll transactions, the purchase or sale of another entity's securities, or the entity's own securities.

Audit Objectives

Consider Fig. 15-2 on page 628 of your textbook. This table presents transaction class and account balance audit objectives in relation to the 5 management assertions for the expenditure cycle.

Materiality

Transactions in the expenditure cycle often affect more financial statement accounts than other cycles combined. The auditor often seeks a low level of risk of material misstatements in the financial statements due to expenditure cycle transactions. The allocation of materiality to accounts affected by this cycle will vary according to the likelihood of misstatements in the account and the probable cost of verifying the account. For example, misstatements are more likely to exist in inventories than plant assets, and it usually costs more to audit inventories than plant assets.

Inherent and Control Risks

Let us consider factors that may lead to misstatement of expenditure cycle transaction:

The auditor must remember inherent limitations of internal control, including the

possibility of management override, collusion, errors due to fatigue or misunderstandings, and failure to adapt the control structure to changed conditions (e.g., rapid growth).

Audit Strategy

Use of either the lower assessed level of control risk approach or primarily substantive approach, or a combination of the two, may be appropriate for auditing the expenditure cycle. For example, the lower assessed level of control risk approach is more efficient for a situation involving a high volume of transactions.

Consideration of Internal Controls

Let us look at the components of internal control as applied to the expenditure cycle.

1-Control Environment

Integrity and ethics are critical here due to many opportunities for employee fraud in doing purchase and cash disbursements. Client firm organizational structure and assignment of authority and responsibility of expenditure cycle activities should be stated clearly.

2-Risk Assessment

Auditors should consider such factors as:

3-Information and Communication

Fig. 15-4 is an overview flowchart that shows the features of manual and computerized accounting systems for processing purchases and cash disbursements. This chapter assumes the use of a voucher system for recording purchases.

4-Monitoring

The auditor should know about feedback from the client's suppliers concerning

payment or delivery problems and communications from external auditors about weaknesses in internal controls or reportable conditions.

Initial Assessment of Control Risk

Auditing procedures to obtain an understanding of the 4 IC elements noted above extend only to the design of policies and procedures. The initial assessment of control risk must be set at the maximum based on information from understanding of these elements only. Tests of controls are often done at the same time as procedures to obtain an understanding. Evidence from concurrent tests of controls may justify a reduction in the initial assessment of control risk for certain related assertions. It can be reduced to slightly below the maximum.

Control Activities–Purchases Transactions

Various Common Documents and Records

Purchase requisition–written request by an employee to the purchasing department

Receiving report–a report prepared on the receipts of goods showing the kinds and quantities of goods received from vendors

Voucher–a form indicating the vendor, amount due, and payment date for purchases received. Usually considered an authorization for recording and paying a liability.

Purchases transactions files–computer file containing data for approved vouchers for purchases that have been received. Used to update the A/P, inventory, and general ledger master file.

Functions

The following functions should be assigned to different individuals or departments:

1-requisitioning goods and services

Capital expenditures and lease contracts require specific approvals. Purchase requisition forms should be signed by a supervisor who has budgetary responsibility for the expenditure category. This represents the start of the transaction trail in support of the existence or occurrence assertion for purchase transactions.

2–preparing purchase orders

Purchase orders should be prenumbered and signed by an authorized

purchasing agent. Copies are distributed internally to the receiving department, the vouchers payable department, and the originating department. Quantity ordered is wiped out on the receiving department copy.

3-receiving the goods

A prenumbered receiving report should be prepared for each order received. The receiving report supports the existence or occurrence assertion for purchase transactions.

4-storing goods received for inventory

Obtaining initials on a copy of the receiving report provides evidence for the existence or occurrence assertion.

5-preparing the payment voucher

The controls over this function and the assertions to which they relate include: establishing the agreement of the details of vendors' invoices with receiving reports and purchase orders and determining the mathematical accuracy of vendors' invoices.

Copies of contracts may be required when the voucher relates to leased assets or long-term suppliers of services or goods. In a computerized system, programmed edit checks are made for valid vendor numbers and reasonableness of amounts.

6-recording the liability

In computerized systems, the purchases transactions file is used to update the A/P, inventory, and G/L master files. In any type of system, an accounting supervisor should check the timeliness of recording by comparing the dates of voucher register entries with dates on the copies of the vouchers.

Illustrative System for Purchase Transactions

Fig. 15-6 is a flowchart of a system for processing purchases transactions. You should be able to understand and interpret this flowchart.

Obtaining the Understanding and Assessing Control Risk

Prior experience with the client, inquiry, observation and inspection of documents are the means by which the auditor obtains an understanding of the control activities component of the internal control aspect (for purchase transactions).

Fig. 15-5 has a list of potential misstatements, controls and account balance audit objectives for purchases. Tests of controls provide the means for ascertaining the effectiveness of such controls. Remember, the extent of tests of controls will vary

inversely with the auditor's planned level of control risk.

The direction of testing must be compatible with the specific audit objective to which the test relates–vouching for existence or occurrence and tracing for completeness. Certain tests may be done as dual purpose tests (e.g., preparing the payment voucher and recording the liability).

A final assessment of control risk can be made and documented for each assertion related to purchase transactions based on evidence collected from procedures to obtain an understanding.

Computer-Assisted Tests of Controls

Tests of effectiveness must be done for any controls that lead to a control risk assessment below the maximum. For general controls over changes to programs and master files, the auditor makes inquiries and inspects documentation.

Application controls tests involve the use of test data to find out whether results produced by the client's program for unpaid vouchers are as expected. Generalized audit software may be used to perform sequence checks and print list of purchase orders, receiving reports, or vouchers with missing numbers.

Control Activities–Cash Disbursement Transactions

Common Documents and Records

Cash disbursements transaction file–information on payments by check to vendors and others. Used for posting to the A/P and general ledger master files.

There are two cash disbursement functions:

1–paying the liability

In a computerized system, the vouchers payable department submits batches of vouchers due for payment to EDP or enters the data on vouchers via terminals. Checks and a check summary are produced. Payment data are entered into a cash disbursements transaction file. Checks should be physically matched with supporting vouchers. Various controls over the preparation and signing of checks and related audit objectives include:

–Independent checks of the agreement of the total of the issued checks with a batch total of the vouchers processed for payment.

–Authorized check signers should ascertain that each check is accompanied by a properly approved unpaid voucher and that the name of the payee and check amount agree with the voucher.

–The check signer should control the mailing of the checks.

–Prenumbered checks should be used.

–A voucher and supporting documents should be stamped or canceled to avoid double payments.

<u>Recording Cash Disbursements</u>

The cash disbursements file created when checks are prepared is used to update the accounts payable master file and general ledger accounts in computerized systems. Controls over the recording of cash disbursements include:

<u>Illustrative System for Cash Disbursements Transactions</u>

A representative system for processing cash disbursements transactions is shown in Fig. 15-8 on. As clerks key in each voucher number, the cash disbursements program is used to prepare a check based on information in the A/P master file. The program enters the payment data in a cash disbursements transaction file and produces a check summary which is compared with the batch total prepared in vouchers payable. In the treasurer's department, an independent check is made to determine the existence of an approved voucher for each check and agreement of the payee's name and the check amount with the voucher. The supporting documents are then stamped paid and the check is signed and mailed with the remittance advice. The cash disbursements update program is then used to update the accounts payable and G/L master files based on data in the cash disbursements transaction file.

<u>Obtaining the Understanding and Assessing Control Risk</u>

Fig. 15-7 contains a partial listing of potential misstatements, necessary controls, and account balance audit objectives for cash disbursements transactions to which each relates.

Test data can be used to test edit checks and other programmed controls pertaining to the preparation and recording of checks. A final assessment of control risk

is made based on collecting the evidence acquired from procedures to obtain an understanding of relevant portions of all five components of IC and related tests of controls.

Substantive Tests of Accounts Payable Balances

A/P is high volume and therefore susceptible to misstatements. The audit of payables places more emphasis on collecting evidence about the completeness assertion relative to the E or O assertion.

Determining Detection Risk

Detection risk for payables assertions is affected by inherent and control risk factors related to both the purchases transactions and cash disbursements transactions classes. Fig. 15-9 specifies risk levels for IR, AR, DR, and CR and various combinations for the five management assertions related to payables. The completeness and V or A assertions for payables need more evidence than the other assertions.

Designing Substantive Tests

Fig. 15-10 contains a list of possible substantive tests that could be applied to A/P. Each of the tests is keyed to one or more of the specific account balance audit objectives for A/P contained in Fig. 15-2.

Initial Procedures

The starting point for substantive tests is tracing the beginning balance of A/P to the prior year's working papers. Other initial activities include reviewing activity in the general ledger for unusual entries and obtaining a listing of amounts owed at the balance sheet date. Ordinarily, the listing is prepared by the client from the unpaid voucher file or the accounts payable subsidiary ledger or master file. The auditor must determine the mathematical accuracy of the listing by refooting the total and verifying that it agrees with the underlying accounting records and the general ledger control account balance.

Analytical Procedures

Several analytical procedures that can be performed to provide evidence about accounts payable are shown in Fig.15-10. An abnormal increase in the accounts payable turnover ratio, or unexpected decreases in the percentage of accounts payable to total current liabilities or in one or more expense account balances, could indicate the possibility of unrecorded accounts payable.

Tests of Details of Transactions

We consider four substantive tests of A/P transactions. The extent of use of each test varies based on acceptable levels of detection risk. The four tests are:

1. Vouch Recorded Payables to Supporting Documentation

In this test, credit entries to A/P are vouched to supporting documents in the client's files such as vouchers, vendor invoices, and purchase orders. Debits are vouched to documentation of cash disbursements transactions, such as paid checks.

2. Perform Purchases Cutoff Test

This test involves ascertaining that purchases transactions occurring near the balance sheet date are recorded in the proper period. This is accomplished by tracing dated receiving reports to voucher register entries and vouching recorded entries to supporting documentation. The test usually covers a period of 5 to 10 business days before and after the balance sheet date. The E or O and completeness assertions are the ones addressed by this test.

Do not forget to accord due consideration to goods in transit at the balance sheet date. Goods shipped FOB shipping point must be included in the inventory and A/P of the buyer. Goods shipped FOB destination point should remain in the inventory of the seller and be left out of the buyer's inventory and A/P (until receipt by the buyer).

3. Perform Cash Disbursements Test

Evidence for the cash disbursements cutoff test may be obtained by personal observation and review of internal documentation. Tracing of the evidence for the last checks written to the accounting records is necessary. The auditor should also trace canceled checks dated within a period of several days before and after the balance sheet date to the dates the checks were recorded.

4. Perform Search for Unrecorded Payables

A review of subsequent payments consists of examining the documentation for checks issued or vouchers paid after the balance sheet date. If evidence purports to show payment for an obligation that existed at the balance sheet date, it should be traced to the A/P listing to ascertain whether it was included. This is an important test for finding out whether payables have been understated or left out.

Other auditing procedures that may indicate unrecorded payables include: (1) checking unmatched purchase orders; (2) inquiring of accounting and purchasing personnel about unrecorded A/P; and (3) reviewing capital budgets, work orders, and construction contracts.

<u>Tests of Details of Balances</u>

1. Confirm A/P

Confirmation of A/P is optional because a confirmation offers no assurance that unrecorded payables will be uncovered and external evidence such as invoices and vendor monthly statements should be available to substantiate the balances. Confirmation of A/P is recommended when detection risk is low or a firm is having trouble in meeting its obligations. The positive form of confirmation should be used if this test is used. The test provides evidence for all A/P assertions.

2. Reconcile Unconfirmed Payables to Vendor Statements

In many cases, vendors provide monthly statements that are available in client files. In such cases, amounts owed to vendors per the client's listing of payables can be reconciled to those statements.