

## FUNCTIONS AND CONTROL ACTIVITIES

### Purchase Returns and Allowances

Purchase adjustment transactions involve the recording of purchase returns and allowances. On occasion, goods received from vendors are defective and must be returned. In addition, vendors offer a number of inducements to purchase inventory. In some cases, vendors will agree to reduce the price for goods rather than have goods returned. On other cases they may agree to pay holding costs for a specific holding period. In many companies, the number and dollar value of these transactions is immaterial. However, in some companies, the potential for misstatements could reach a material amount.

Each of these transactions results in reducing payables and expenses and in improving reported liquidity and earnings. Sound financial reporting needs to establish adequate controls over these transactions to prevent their abuse in earnings management activities. Accordingly, control activities useful in reducing the risk of misstatements focus on establishing the existence or occurrence of such transactions (EO3) and include the following:

- All purchase returns should be authorized by the vendor (EO3).
- Goods should be returned 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 debit memo information with the authorization for purchase return and the shipping documents (EO3, VA3).
- The computer generates a report of all authorized purchase returns that have not been shipped or have not resulted in a debit memo (C3).

Furthermore, there should be adequate segregation of duties between obtaining authorization for purchase returns, shipping goods, and recording debit memos.

When there is the potential for material misstatements from purchase adjustments transactions, the auditor should obtain an understanding of all relevant aspects of the internal control structure components and consider the factors that affect the risk of such misstatements. If purchase adjustments are estimated at quarter end, management should establish controls to ensure that adjustments are made based on reliable information and that adjustments are consistent from quarter to quarter. A disclosure committee should review these estimates if they could aggregate with other adjustments to an amount that is material to the financial statements (VA4, PD7).

### OTHER CONTROLS IN THE EXPENDITURE CYCLE

The previous discussion focused on controls over transactions. It is also important to control balances and disclosures.

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. 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.

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).

Finally, management should establish controls over the occurrence and rights and obligations of disclosures (PD4), the completeness of disclosures (PD5), the understandability of disclosures (PD6), and the accuracy and valuation of information included in disclosures (PD7). Public companies normally accomplish this task through the workings of a disclosure committee that is independent of the CFO or controller, and includes individuals who are knowledgeable about GAAP and the transactions and disclosures relevant to the expenditure cycle.

## TEST OF CONTROLS

### Audit Decision 9

■ What are the relevant aspects of tests of controls when the auditor plans to assess control risk below the maximum for expenditure cycle transactions?

Many auditors plan to test controls in the purchases cycle because of the high volume of routine transactions in this cycle. Public company auditors test controls to support an opinion on internal controls. Private company auditors will test controls that appear to be effective because of the audit efficiencies that exist with this strategy.

If the auditor plans to assess control risk as low for expenditure cycle assertions, he or she will usually have to:

- Test the effectiveness of general controls.
- Use computer-assisted audit techniques (CAATs) to evaluate the effectiveness of programmed controls.
- Test the effectiveness of procedures to follow up on exceptions identified by programmed controls.

For example, the auditor might use test data to determine whether expected results appear on exception reports when he or she submits

- Missing or invalid vendor code.
- Transactions reporting receivings in quantities different from the amount ordered (both over and under).
- Prices, vendor numbers, account numbers, or other information on vouchers that do not match information on the purchase order.
- Voucher quantities that do not match quantities on receiving reports.

The auditor might also use generalized audit software or a utility program to perform sequence checks and print lists of purchase orders, receiving documents, or vouchers whose numbers are missing in designated computer files.

## LEARNING CHECK

- 15-12 a. Explain the economic substance of purchase adjustments.  
b. State three types of controls pertaining to purchase adjustment transactions and identify their common focus.
- 15-13 a. Explain why controls over expenditure cycle transactions should also control the accounts payable balance.  
b. Explain the primary control over the accounts payable balance itself.  
c. How is the rights and obligations assertion controlled for accounts payable?  
d. How are disclosures controlled for accounts payable?



**15-14** Using the information in Figures 15-6 and 15-7 develop a test of controls for each assertion related to purchases and cash disbursements.

## KEY TERMS

Debit memo, p. 712

Shipping report, p. 712

Purchase return authorization, p. 712

## SUBSTANTIVE TESTS OF ACCOUNTS PAYABLE BALANCES

Accounts payable is usually the largest current liability in a balance sheet and a significant factor in evaluating an entity's short-term solvency. Like accounts receivable, it is typically affected by a high volume of transactions and thus is susceptible to misstatements. However, as compared with the audit of asset balances, the audit of payables places greater emphasis on the completeness assertion relative to the existence or occurrence assertion. The reason for this is that if management were motivated to misrepresent payables, it would likely be to understate them in order to report a more favorable financial position. In addition, there is an inherent risk that vendor's invoices may not be received on a timely basis and payables may be recorded in a period after the receipt of goods or services.

Our attention here is focused on trade payables arising from expenditure cycle transactions. Other payables, such as wages and payroll taxes and various non-current liabilities, are covered in other cycle chapters.

### DETERMINING DETECTION RISK FOR TESTS OF DETAILS

An example risk matrix for the purchases cycle and accounts payable assertions is presented in Figure 15-9. The following explains the development of preliminary audit strategies for assertions that are consistent with this example risk matrix.

#### Existence and Occurrence

The existence and occurrence assertion for purchases and accounts payable represents a significant inherent risk because of the potential for employee fraud and misappropriation of assets. As a result, inherent risk is assessed at high for this assertion.

Recall from Chapter 11 that the combined control risk assessment for accounts payable is a function of internal controls over the occurrence of purchases (low) and the completeness of cash disbursements (low) and purchase adjustments (moderate). As a result, a conservative combined risk assessment for the existence of accounts payable would be moderate. A common internal control over the occurrence of purchases would be having the computer match sales voucher information with information from the receiving report. An example internal control over the completeness of disbursements would include a computer report of payments due to vendors but not yet paid. This control also depends on strong controls over the completeness of vouchers payable. Internal controls over the completeness of purchase returns might include a regular report of all authorized

#### Audit Decision 10

■ What are the factors involved in determining the acceptable level of tests of details risk for accounts payable assertions?

**Figure 15-9** ■ Example Risk Matrix for Accounts Payable Assertions

Risk Component	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure
Audit Risk	Very low	Very low	Very low	Very low	Very low
Inherent Risk	High	Max	Moderate	High	Max
Control Risk—Purchase Transactions	Low	Low	Moderate	Low	Moderate
Control Risk—Cash Disbursement Transactions	Low	Low	Moderate	Low	Moderate
Control Risk—Purchase Adjustment Transactions	Low	Moderate	Moderate	Low	Moderate
Combined Control Risk for Accounts Payable Tests	Moderate	Low	Moderate	Low	Moderate
Analytical Procedures Risk	High	High	High	High	High
Acceptable Test of Details Risk	Low	Low	Moderate	Moderate	Low

purchase returns that have not resulted in the generation of debit memos. The moderate control risk assessment for purchase returns is related to the challenge of obtaining control over the population of authorized returns.

The auditor might perform analytical procedures similar to those explained in Figure 15-4. As a result, the appropriate level of detection risk for test of details is low. The primary test of details would involve the vouching transactions to underlying receiving reports and approved vendor's invoices. Based on the combined control risk assessment of moderate, the auditor might perform tests of transactions at an interim date. Some level of vouching or confirming payables at year-end also provides evidence regarding the validity of this assertion.

### Completeness

The auditor will likely assess inherent risk for the completeness assertion as maximum because of the risk of unrecorded liabilities.

When considering the combined control risk assessment for the completeness of receivables, the auditor should evaluate the completeness assertions for purchases (low in this example) with the existence and occurrence assertion for cash disbursements (low) and for purchase adjustments (low). Internal controls over the completeness of purchases would usually include daily followup on items received that had not resulted in vouchers. Controls over the occurrence of cash disbursements would include comparison of recorded cash disbursement with the underlying voucher. This control depends on controls over the existence of recorded purchases. Finally controls over the occurrence of purchase returns would include matching of debit memo information with underlying shipping information.



Analytical procedures related to the completeness of purchases and payables would involve a comparison of purchases to the underlying physical business such as a comparison of purchases to production levels, and being alert to a current ratio that just looks too good. Focusing on significant decreases in accounts payable turn days is a rather blunt tool, so analytical procedures risk is often set at high.

In this situation the auditor assesses test of details risk as low. The auditor often performs substantive tests by taking a sample of purchases after the end of the year to determine if they should have been recorded in the prior period. With a low test of details risk assessment the auditor would perform extensive tests after year-end to test the accuracy of purchases cutoff.

### **Rights and Obligations**

The rights and obligations assertion addresses the issue of whether accounts payable are obligations of the entity at the balance sheet date. A consolidated entity needs to ensure that the recorded obligations are the obligations of the consolidated entity. This is a moderate inherent risk as entities rarely record obligations that they do not owe. Owner-managed companies need to make sure that they do not record obligations of the owner as obligations of the company. Rights and obligations is often controlled at the transaction level by ensuring that only the obligations of the entity are recorded in the books of original entry as payables.

Analytical procedures are a fairly blunt tool for auditing this objective. They would have to provide evidence that payables appear to be significantly overstated. Hence, auditors often rely on direct tests of transactions, vouching transactions to underlying source documents, to obtain competent evidence regarding the rights and obligations assertion.

### **Valuation or Allocation**

The assessment of inherent risk for the valuation or allocation assertion is often set at high just because of the high volume of transactions that flow through accounts payable.

Controls over the valuation or allocation assertion involve the controls over the valuation of purchases, cash disbursements, and purchase adjustments. These might include computer comparison of prices on voucher invoices with underlying vendor's invoices and the purchase order, comparison of recorded cash disbursements with the recorded voucher, and comparison of prices on debit memo with the voucher and the vendor's invoice. These are routine transactions that can be effectively controlled, so a strong system of internal control should be able to restrict control risk to a low level.

Analytical procedures usually involve computing the entity's accounts payable turn days. This is a rather blunt tool for careful analysis of valuation issues, so analytical procedures risk is often set at high.

The valuation of payables is often tested simultaneously with the existence of payables. Auditors normally use a combination of vouching transactions to underlying vendor's invoices during tests of transactions at an interim date and some level of vouching or confirming payables at year-end.

## Presentation and Disclosure

The greatest risk associated with presentation and disclosure is the risk of misclassification of expenses as capital assets. The GAO Report on Financial Statement Restatements showed that misclassification of costs and expenses was the second most common cause of restatements after revenue recognition problems. As a result, inherent risk is often set at maximum for this assertion. This problem focuses more on the debit side of the purchase, rather than the credit to accounts payable.

Internal controls over the classification of expenditures must be implemented at early stages of a transaction. The first assignment of account classifications usually happens with the purchase requisition or purchase order, and the recording of the transaction is compared with this information. Often account classifications are assigned to the individual who initiates a purchase requisition to minimize the risk of classification errors. Hence, if a particular manager initiates a purchase requisition, the transaction must be charged to that individual's responsibility center. In our example control risk is assessed at moderate because of the degree of subjectivity in this process.

Analytical procedures might focus on amount of certain expenses (repair and maintenance) from year to year, but this is not a precise test. Earning management activities often ensure that these relationships look reasonable. Hence, the auditor must devote significant attention to auditing the classification of transactions substantively to restrict test of details risk to a low level. This involves vouching transactions to underlying vendor's invoices during tests of transactions at an interim date and again at year-end, and reevaluating the appropriateness of account classifications assigned to the transactions. In addition, the auditor often performs tests associated with investing and financing activities to specifically evaluate issues associated with the classification of assets. These other tests are discussed in Chapter 17.

## DESIGNING SUBSTANTIVE TESTS

Recall that the acceptable level of detection risk for each significant financial statement assertion is achieved by gathering evidence from appropriately designed substantive tests. The general framework for developing audit programs for substantive tests that was explained in Chapter 12 and illustrated in Chapter 14 for accounts receivable can also be used in designing substantive tests for accounts payable. A listing of possible substantive tests that might be included in an audit program developed on this basis appears in Figure 15-10. Note that each of the tests in the figure is keyed to one or more of the specific account balance audit objectives for accounts payable from Figure 15-2. Also note that multiple tests are keyed to each account balance audit objective. Each of the tests is explained below, including comments on how some tests can be tailored based on the applicable acceptable level of detection risk to be achieved.

### Audit Decision 11

■ How does the auditor determine the elements of an audit program for substantive tests to achieve specific audit objectives for accounts payable?

## Initial Procedures

The starting point for every audit test is obtaining an understanding of the business and industry. Understanding the significance of the purchase cycle to the entity provides a context for important risk assessments. Understanding the company's economic drivers, standard trade terms, and the extent of concentration of



**Figure 15-10 ■ Possible Substantive Tests of Accounts Payable Assertions**

Category	Substantive Test	Specific Audit Objectives
Initial Procedures	<ol style="list-style-type: none"> <li>1. Obtain an understanding of the business and industry and determine:               <ol style="list-style-type: none"> <li>a. The significance of purchases and accounts payable to the entity.</li> <li>b. Key economic drivers that influence the entity's purchases and resultant account payables.</li> <li>c. Standard trade terms in the industry, including seasonal dating, etc.</li> <li>d. The extent of concentration of activity with suppliers and related purchase commitments.</li> </ol> </li> <li>2. Perform initial procedures on the accounts payable balance and records that will be subjected to further testing.               <ol style="list-style-type: none"> <li>a. Trace beginning balance for accounts payable to prior year's working papers.</li> <li>b. Review activity in general ledger account for accounts payable and investigate entries that appear unusual in amount or source.</li> <li>c. Obtain listing of accounts payable at balance sheet date and determine that it accurately represents the underlying accounting records by:                   <ol style="list-style-type: none"> <li>i. 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.</li> <li>ii. Testing agreement of vendors and balance on listing with those included in the underlying accounting records.</li> </ol> </li> </ol> </li> </ol>	<p>All</p> <p>VA4</p> <p>PD1, PD2, PD3, EO1, EO2, EO3</p> <p>VA4</p> <p>VA4</p>
Analytical Procedures	<ol style="list-style-type: none"> <li>3. Perform analytical procedures:               <ol style="list-style-type: none"> <li>a. Develop an expectation for accounts payable using knowledge of the entity's business activity, normal trade terms, and its history of accounts payable turnover.</li> <li>b. Calculate ratios:                   <ol style="list-style-type: none"> <li>i. Accounts payable turnover (purchases ÷ accounts payable).</li> <li>ii. Accounts payable to total current liabilities.</li> </ol> </li> <li>c. Analyze ratio results relative to expectations based on prior years, industry data, budgeted amounts, or other data.</li> <li>d. Compare expense balance to prior year or budgeted amounts for indications of possible understatement related to unrecorded payables.</li> </ol> </li> </ol>	<p>All</p>
Tests of Details of Transactions	<ol style="list-style-type: none"> <li>4. Vouch a sample of recorded expenditure cycle transactions to supporting documentation.               <ol style="list-style-type: none"> <li>a. Vouch accounts payable credits to supporting vouchers, vendor invoices, receiving reports, and purchase orders and other supporting information.</li> <li>b. Vouch accounts payable debits to cash disbursements or purchase returns memoranda.</li> </ol> </li> <li>5. Perform purchases cutoff test.               <ol style="list-style-type: none"> <li>a. Select a sample of recorded purchase transactions from several days before and after year-end and examine supporting vouchers, vendor invoices, and receiving reports to determine that purchases were recorded in the proper period, or</li> <li>b. 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.</li> </ol> </li> <li>6. Perform cash disbursements cutoff test.               <ol style="list-style-type: none"> <li>a. Observe the number of the last check issued and mailed on the last day of the audit period and trace to the accounting records to verify accuracy of cutoff, or</li> <li>b. Trace dates of "paid" checks returned with year-end cutoff bank statements to dates recorded.</li> </ol> </li> </ol>	<p>EO1, PD1, VA1, EO4</p> <p>EO2, PD2, VA2, EO4, EO3, PD3, VA3</p> <p>EO1, C1</p> <p>EO1, C1</p> <p>EO2, C2</p>

*(continues)*

Figure 15-10 ■ (Continued)

Category	Substantive Test	Specific Audit Objectives
	7. Purchase return cutoff test. a. Determine purchase returns shipped back to vendors for a period of several days before and after year-end and determine that transactions are recorded in the proper period. b. Vouch the last purchase returns recorded in the books of original entry to vendor’s authorization and shipping reports.	EO3, C3
	8. Perform search for unrecorded liabilities. a. Examine subsequent payments between balance sheet date and end of fieldwork, and when related documentation indicates payment was for obligation in existence at balance sheet date, trace to accounts payable listing. b. Examine documentation for payables recorded at year-end that are still unpaid at end of fieldwork. c. Investigate unmatched purchase orders, receiving reports, and vendor invoices at year-end. d. Inquire of accounting and purchasing personnel about unrecorded payables. e. Review capital budgets, work orders, and construction contracts for evidence of unrecorded payables.	C4, RO1
	9. Confirm accounts payable. a. Identify major vendors by reviewing voucher register or accounts payable subsidiary ledger or master file and send confirmation requests to vendors with large balances, unusual activity, small or zero balances, and debit balances. b. Investigate and reconcile differences.	EO4, VA4, RO1
Tests of Details of Balances	10. Reconcile unconfirmed payable to monthly statements received by client from vendors.	EO4, VA4, RO1
Presentation and Disclosure	11. Compare statement presentation with GAAP. a. Determine that payables are properly identified and classified as to type and expected period of payment.	PD4, PD7
	b. Determine whether there are debit balances that are significant in the aggregate and that should be reclassified.	PD4, PD7
	c. Determine the appropriateness of disclosures pertaining to related party or collateralized payables.	PD4, PD7
	d. Inquire of management about existence of undisclosed commitments or contingent liabilities.	PD4, PD7
	e. Evaluate the completeness of presentation and disclosures for payables in drafts of financial statements to determine conformity to GAAP by reference to disclosure checklist.	PD5
	f. Read disclosures and independently evaluate their classification and understandability.	PD6

business with certain suppliers provides the context for evaluating the results of analytical procedures, tests of controls, and substantive tests. Procedures performed to obtain this understanding were discussed earlier in the chapter.

Another initial procedure for substantive tests of accounts payable is tracing the beginning balance to the prior year’s working papers, and using generalized audit software to scan the general ledger account for any unusual entries and to develop a listing of amounts owed at the balance sheet date. Ordinarily, the client provides a listing of the unpaid voucher file, the accounts payable subsidiary ledger, or master file in electronic form. The auditor can also use generalized audit software to determine the mathematical accuracy of the listing by refooting the total and by verifying that it agrees with the general ledger account balance.



## Analytical Procedures

The importance of analytical procedures was discussed earlier in the chapter. The auditor's goal is to develop an expectation of payable account balances and the relationship between accounts payable and other key accounts such as purchases or inventory. Several analytical procedures that can be performed to provide evidence about accounts payable are shown in Figure 15-4. An abnormal decrease in the accounts payable turnover ratio or unexpected increases in the current ratio may provide indicators of understated liabilities. Analytical procedures are performed in final stages of the engagement to ensure that the evidence evaluated in details tests is consistent with the overall picture reported in the financial statements.

## Tests of Details of Transactions

There are five major substantive tests of details of accounts payable transactions as shown in Figure 15-10 and as discussed in the following subsections. Recall that in performing these tests, the auditor is primarily concerned with detecting understatements of recorded payables as well as unrecorded payables. The extent to which each test is performed varies based on the acceptable levels of detection risk specified for the related assertions.

### Vouch Recorded Payables to Supporting Documentation

In this test, credit entries to accounts payable are vouched to supporting documentation in the client's file such as vouchers, vendor invoices, receiving reports, and purchase orders. Debits to accounts payable are vouched to documentation of cash disbursement transactions, such as paid checks, or memoranda from vendors pertaining to purchase returns and allowances. Some vouching may have been performed during interim work, such as parts of dual-purpose tests along with tracings from source documents to accounting records. The extent of vouching is directly related to the auditor's conclusions about inherent risk, analytical procedures risk, and control risk. This test primarily provides evidence for the specific audit objectives related to four of the five assertions, excluding completeness. The applicability to the completeness assertion is limited because, whereas the improper reduction of recorded payables through invalid debits may be detected, the test will not detect payables that have never been recorded.

### Perform Cutoff Test

The **purchases cutoff tests** involves determining that purchase transactions occurring near the balance sheet date are recorded in the proper period. This may be done by tracing dated receiving reports to voucher register entries and vouching recorded entries to supporting documentation. The test usually covers a period of five to ten business days before and after the balance sheet date. Evidence from the test pertains to the existence or occurrence and completeness assertions for accounts payable.

In examining documentation as part of this test, special consideration must be given to goods in transit at the balance sheet date. Goods shipped FOB (free on board) shipping point should be included in the inventory and accounts payable of the buyer. In contrast, goods in transit shipped FOB destination should remain

in the inventory of the seller and be excluded from the buyer's inventory and accounts payable until arrival at the buyer's receiving department. In performing this test, the auditor should determine that a proper cutoff is achieved in the taking of the physical inventory, as explained further in Chapter 16, as well as in the recording of the purchase transactions.

A proper cutoff of cash disbursement transactions at the end of the year is essential to the correct presentation of cash and accounts payable at the balance sheet date. As in the case of the cash receipts cutoff test described in the preceding chapter, evidence for the **cash disbursement cutoff test** may be obtained by personal observation and review of internal documentation. When the auditor can be present at the balance sheet date, he or she can personally determine the last check written and mailed by the client. Subsequent tracing of this evidence to the accounting records will verify the accuracy of the cutoff. Alternatively, the auditor can trace "paid" checks dated within a period of several days before and after the balance sheet date to the dates the checks were recorded. Evidence from this test also pertains to the existence or occurrence and completeness assertions for accounts payable.

**Purchase return cutoff tests** are similar to other cutoff tests. First, the auditor should start with the shipping records for a period of five to ten days before an after year-end to ensure that purchase returns are accurately recorded in the accounting records. Then the auditor should go from the accounting records back to evidence in the shipping records to verify the accuracy of the last purchase returns recorded by the entity.

### Perform Search for Unrecorded Payables

The **search for unrecorded accounts payable** consists of procedures designed specifically to detect significant unrecorded obligations at the balance sheet date. Thus, it relates to the completeness assertion for accounts payable.

A common procedure involves examining **subsequent payments**, which consists of examining the documentation for checks issued or vouchers paid after the balance sheet date. When the documentation indicates the payment is for an obligation that existed at the balance sheet date, it is traced to the accounts payable listing to determine whether it was included. This test is performed toward the end of fieldwork to enhance the opportunity of obtaining evidence concerning payables that were intentionally or inadvertently excluded from the listing of payables at the statement date. Thus, the test extends beyond the periods used in the cutoff tests described earlier.

Usually vendors will seek payment, even if a liability is not recorded at the balance sheet date. Hence, this may be an effective search for unrecorded liabilities. The auditor can also search this subsequent period looking for overstatements of subsequent payments and may focus on larger transactions.

Documentation supporting payables recorded but remaining unpaid through the end of fieldwork should also be examined on a test basis. This may also reveal obligations that existed but that were unrecorded as of the balance sheet date. Other procedures that may reveal unrecorded payables include (1) investigating unmatched purchase orders, receiving reports, and vendor invoices at year-end, (2) inquiring of accounting and purchasing personnel about unrecorded payables, and (3) reviewing capital budgets, work orders, and construction contracts for evidence for unrecorded payables.



## Tests of Details of Balances

Two tests included in this category are (1) confirming accounts payable and (2) reconciling unconfirmed payables to monthly statements received by the client from vendors.

### Accounts Payable Confirmations

Unlike the confirmation of accounts receivable, there is no presumption made about the **confirmation of accounts payable**. This procedure is optional because (1) confirmation offers no assurance that unrecorded payables will be discovered and (2) 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 the detection risk is low, there are individual creditors with relatively large balances, or a company is experiencing difficulties in meeting its obligations. As in the case of confirming accounts receivable, the auditor must control the preparation and mailing of the request and should receive the responses directly from the respondent.

When the confirmation is to be undertaken, accounts with zero or small balances should be among those selected for confirmation because they may be more understated than accounts with large balances. In addition, confirmations should be sent to major vendors who (1) were used in the prior year but not in the current year and (2) do not send monthly statements. The positive form should be used in making the confirmation request as illustrated in Figure 15-11. It may be observed that the confirmation does not specify the amount due. In confirming a payable, the auditor prefers to have the creditor indicate the amount due because that is the amount to be reconciled to the client's records. Note that information is also requested regarding purchase commitments of the client and any collateral for the payable.

This test produces evidence for all accounts payable assertions. However, the evidence provided for the completeness assertion is limited because of the possible failure to identify and send confirmation requests to vendors with whom the client has unrecorded obligations.

### 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. The evidence from this procedure applies to the same assertions as confirmations, but is less reliable because the vendors' statements were sent to the client rather than directly to the auditor. In addition, statements may not be available from certain vendors.

## Tests of Details of Disclosures

Figure 15-10 describes a number of tests of disclosures for the expenditure cycle. The auditor must be knowledgeable about the statement presentation and disclosure requirements for accounts receivable and sales under GAAP. Accounts payable should be properly identified and classified as a current liability. If the accounts payable balance includes material advance payments to some vendors for future delivery of goods and services, such amounts should be reclassified as advances to suppliers and included as assets. In addition, disclosures may be

**Figure 15-11** ■ Accounts Payable Confirmation

**Highlift Company**

P.O. Box 1777  
Cleveland, Ohio 39087

January 4, 20X1

Supplier, Inc.  
2001 Lakeview Drive  
Cleveland, Ohio 39098

Dear Sir or Madam:

Will you please send directly to our auditors, Reddy & Abel, Certified Public Accountants, an itemized statement of the amount owed to you by us at the close of business on December 31, 20X0? Will you please also supply the following information:

Amount not yet due \$ \_\_\_\_\_

Amount past due \$ \_\_\_\_\_

Amount of purchase commitments \$ \_\_\_\_\_

Description of any collateral held:

A business reply envelope addressed to our auditors is enclosed. A prompt reply will be very much appreciated.

Very truly yours.

*D.R. Owens*

Controller  
Highlift Company



required for collateralized and related-party payables, purchase commitments, and contingent liabilities. Thus, management's presentation and disclosures must be compared with these GAAP requirements. Evidence relevant to these matters should be obtainable by inquiring of management and reviewing minutes of board of directors' meetings and loan agreements. Evidence is also obtained through the audit procedures performed to test other assertions. Management's representations on these matters should be obtained in writing in a client representation letter as one of the final steps in the audit, as explained in Chapter 19.

## OTHER ASSURANCE SERVICES

### Audit Decision 12

■ How does the auditor use the knowledge obtained during the audit of the expenditure cycle to support other assurance services?

Generally accepted auditing standards do not require that the auditor perform other assurance services. However, many auditors develop industry specializations so that they can understand industry trends and better identify risks associated with financial statements not presenting fairly financial position, results of operations, or cash flows. The client and its board of directors usually want to take full advantage of the auditor's knowledge.

Consider the following example regarding a not-for-profit agency that performed services for a state agency. While completing an audit of the expenditure cycle the auditor recognized a change in business practices. Previously the state subcontracted with the agency for certain services and had a practice of paying a flat monthly fee at the beginning of the month for the delivery of services. Furthermore, the state obtained no reporting from the not-for-profit on the number of individuals who received service from the subcontractor. The not-for-profit entity had a built-in fixed cost with little accountability. When it came time to renegotiate the contract, the state negotiated a contract where the not-for-profit was reimbursed at the end of the month based on the number of persons served. This resulted in a significant cash outflow for the not-for-profit agency. Now cash was going out before it was reimbursed for services. Managers, who were focused on delivering a social need, paid little attention to preparing billing for services performed. They had not had to do this in the past. Based on recommendations from the auditor, the entity discovered that it had to more carefully monitor its performance of services to make sure that it served a sufficient number of individuals to cover its costs. It also had to ensure that billings were sent on a timely basis. Based on audit recommendations, the entity was also able to negotiate a cash advance from the state to address the cash flow problems that were created. This is one example of how the auditor might use the knowledge obtained during the audit, to deliver additional high-value services to audit clients.

Consider the following example relating to performance measurement services. In the process of performing the audit, the auditor may benchmark an entity's expenditures against others in the industry. For example, for the year ending January 28, 2000, Dell Computer took an average of 6 days to turn its inventory, 34 days to turn its receivables, and 43 days to clear its payables, resulting in obtaining 3 days of operating cash flow before it had to settle its lia-

bilities. No cash was needed to fund the operating cycle. An important service offered by CPAs is helping their clients anticipate this type of opportunity and helping them develop the vision of how to make this type of positive cash flow a reality.

## [ LEARNING CHECK ]

---

- 15-15** a. Which assertion is of primary importance to the auditor in auditing accounts payable? Why?  
 b. Indicate the relationship of control risk assessments for expenditure cycle transactions to the completeness assertion for accounts payable.
- 15-16** a. Identify the substantive tests that apply to the completeness assertion for accounts payable.  
 b. For each of the foregoing tests, indicate the other assertions to which they may relate.
- 15-17** Chris Cole believes the auditor's responsibilities for confirming accounts payable are the same as those for accounts receivable. Do you agree with Chris? Explain.
- 15-18** a. How does the auditor perform (1) a purchases cutoff test and (2) a cash disbursement cutoff test?  
 b. What assertions are affected by these tests?
- 15-19** Distinguish among the following tests and indicate the assertion to which each test pertains.  
 a. Vouch recorded payables to supporting documentation.  
 b. Examine subsequent payments.  
 c. Determine that payables are properly identified and classified.
- 15-20** Develop several examples of how the auditor might use his or her knowledge of the expenditure cycle to deliver other assurance services to an audit client.

## [ KEY TERMS ]

---

Cash disbursement cutoff test, p. 722  
 Confirmation of accounts payable,  
 p. 723  
 Purchases cutoff tests, p. 721

Purchase return cutoff tests, p. 722  
 Search for unrecorded accounts  
 payable, p. 722  
 Subsequent payments, p. 722

## [ FOCUS ON AUDIT DECISIONS ]

This chapter focuses on the practical aspects of auditing the expenditure cycle. The chapter pays particular attention to audit planning concerns related to the expenditure cycle, specific internal controls that are tailored to the expenditure cycle, and substantive tests for the expenditure cycle. Figure 15-12 summarizes the audit decisions discussed in Chapter 15 and provides page references indicating where these decisions are discussed in more detail.



**Figure 15-12 ■ Summary of Audit Decisions Discussed in Chapter 15**

Audit Decision	Factors that Influence the Audit Decision	Chapter References
D1. What is the nature of the expenditure cycle, and how are specific audit objectives developed for the expenditure cycle?	The expenditure cycle includes three major classes of transactions: (1) purchases, (2) cash disbursements, and (3) purchase adjustments. The primary balance in the expenditure cycle is accounts payable. Figure 15-2 develops specific audit objectives for the audit of the expenditure cycle.	pp. 690–691
D2. How does understanding the entity and its environment affect audit planning decisions in the expenditure cycle?	Different companies in different industries experience various risks associated with the expenditure cycle. Figure 15-3 provides examples of five different industries and how knowledge of the entity and its environment can be used to develop expectations of the financial statements and to assess the risk of material misstatement. The chapter also discusses common inherent risks associated with the expenditure cycle. The most significant inherent risk is associated with unrecorded liabilities. Cash disbursements present an opportunity for misappropriation of assets. Additional inherent risk factors are discussed in the chapter.	pp. 691–692
D3. What are important inherent risks in the expenditure cycle?	Common inherent risks in the expenditure cycle include pressures to understate payables and expenses (completeness problems), vendors may be tardy in sending invoices (completeness problems), and the double payment of invoices (existence problems). In addition, the auditor may have to modify audit strategies to accommodate the client's use of electronic data interchange or electronic imaging systems.	pp. 692–695
D4. How might the results of analytical procedures indicate potential misstatements in the expenditure cycle?	Analytical procedures are both cost effective and often identify assertions that need audit attention. Figure 15-4 explains a number of analytical procedures that can be used in the expenditure cycle. Additional analytical procedures that use nonfinancial data are also explained in the chapter discussion.	p. 695
D5. What are the relevant aspects of internal control components for the expenditure cycle?	This section of the chapter reviews important aspects of the control environment, risk assessment, information and communication, and monitoring that are relevant to the expenditure cycle. It is important for students to understand the documents found in the information and communication system as these represent the audit trail. Figure 15-5 provides a flowchart depiction of the recording of purchases.	pp. 696–698
D6. What should be considered in evaluating control activities for purchase transactions?	Making a purchase involves initiating the purchase, receiving goods or services, and recording the purchase. This section explains the documents and records involved in recording credit sales. Figure 15-6 provides a series of example control activities that control each assertion related to recording purchases.	pp. 699–707

*(continues)*

Figure 15-12 ■ (Continued)

Audit Decision	Factors that Influence the Audit Decision	Chapter References
D7. What should be considered in evaluating control activities for cash disbursements transactions?	Figure 15-8 provides a flowchart depiction of the recording of cash disbursement in the consideration stage of a purchase transaction. Figure 15-7 provides a series of example control activities that control assertions related to cash disbursements.	pp. 707–711
D8. What should be considered in evaluating control activities for purchase adjustments?	Purchase adjustments are less frequent than purchases or cash disbursements, but may be material to the financial statement. The chapter discussion explains the documents and records involved in recording purchase adjustments and provides a series of example control activities that control assertions related to purchase adjustment transactions.	pp. 712–714
D9. What are the relevant aspects of tests of controls when the auditor plans to assess control risk below the maximum for expenditure cycle transactions?	Many of the control activities in the expenditure cycle involve programmed controls. In order for the auditor to assess control risk as low, the auditor needs to (1) test computer general controls, (2) test the computer application itself, and (3) test the effectiveness of manual followup activities. Examples of tests of computer application controls are provided in this chapter discussion.	p. 714
D10. What are the factors involved in determining acceptable level of tests of details risk for accounts payable assertions?	In determining the appropriate level of test of details risk, the auditor should consider inherent risk, control risk, and analytical procedures risk. This chapter discussion provides example discussions of each of these risk assessments, Figure 15-9, and the auditor's response in terms of preliminary audit strategy for each of the five basic financial statement assertions.	pp. 715–718
D11. How does the auditor determine the elements of an audit program for substantive tests to achieve specific audit objectives for accounts payable?	The development of an audit program for accounts payable uses the framework developed in Chapter 12 to design substantive tests for the expenditure cycle. Figure 15-10 focuses on the nature of substantive tests for the expenditure cycle. It summarizes the initial procedures, analytical procedures, tests of details of transactions, tests of details of balances, and tests of details of disclosures relevant to the expenditure cycle. The chapter discussion explores these tests in more detail.	pp. 718–725
D12. How does the auditor use the knowledge obtained during the audit of the expenditure cycle to support other assurance services?	Once the auditor has completed an audit of the expenditure cycle, the auditor should have information that supports an audit opinion as well as recommendations related to improvements in internal controls. In addition, the auditor probably has obtained knowledge that may be relevant to other assurance services. This final section of the chapter provides examples of how knowledge obtained while auditing the expenditure cycle can be used to support other assurance services.	pp. 725–726

**objective questions**

Objective questions are available for the student at [www.wiley.com/college/boynton](http://www.wiley.com/college/boynton)



## comprehensive questions

- 15-21 **(Knowledge of the entity and its environment)** Your client is a local independent grocer with five stores who competes with a number of large grocery chains. It purchases goods from several large grocery supply chains as well as from various vendors that sell directly to the store. Some vendors offer various advertising rebates or other price concession for stocking goods.

**Required**

Explain how your knowledge of the business and industry would impact your audit of total purchases and accounts payable for the client.

- 15-22 **(Analytical Procedures)** In planning the audit of Construction Industry Resources, Inc., a building supply company, you have completed analytic procedures relevant to purchases and inventory. The results of these procedures are included in Exhibit 15-22.

**EXHIBIT 15-22 SELECTED FINANCIAL INFORMATION (\$000)**

	X1	X2	X3	X4	X5
Building Supply Revenues	\$ 90,100	\$ 99,380	\$ 117,468	\$ 137,085	\$ 160,800
Lumber Brokerage Revenues	\$ –	\$ –	\$ 45,021	\$ 63,480	\$ 90,141
	<u>\$ 90,100</u>	<u>\$ 99,380</u>	<u>\$ 162,489</u>	<u>\$ 200,564</u>	<u>\$ 250,941</u>
Inventory Turn Days					
Building Supplies	32	34	31	33	27
Lumber Brokerage			7	6	6
Gross Margin					
Building Supplies	20.1%	18.5%	18.6%	19.1%	18.0%
Lumber Brokerage			3.9%	4.1%	4.2%

**Required**

Analytical procedures show that inventory turnover decreased from 31–34 days to 27 days, and gross margins declined to the lowest level in five years. What might this indicate about the risk of misstatement with respect to inventory and inventory purchases?

- 15-23 The following information was taken from the accounting records for Aurora Manufacturing, Inc.:

	YEAR 5 UNAUDITED	YEAR 4 AUDITED	YEAR 3 AUDITED	YEAR 2 AUDITED	YEAR 1 AUDITED
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
<b>Industry Median</b>					
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	

**Required**

- a. Calculate the following information and ratios for years 2, 3, 4, and 5:
  - Purchases
  - Accounts payable turn days
  - Cost of goods sold to accounts payable
  - Current ratio
- b. Describe the implications of the resulting ratios for the auditor's audit strategy in year 5. What specific audit objectives are likely to be misstated? How should the auditor respond in terms of potential audit tests?

- 15-24 **(Internal control questionnaire—purchasing functions)** Green, CPA, has been engaged to audit the financial statements of Star Manufacturing, Inc. Star is a medium-sized entity that produces a wide variety of household goods. All acquisitions of materials are processed through the purchasing, receiving, accounts payable, and treasury functions.

**Required**

Prepare the purchase order and receiving segments of the internal control questionnaire to be used in the evaluation of Star's internal control structure. Each question should elicit either a *Yes* or *No* response.

Do not prepare segments of the internal control questionnaire for other functions.

Do not discuss the internal controls over purchases.

AICPA (adapted)

- 15-25 **(Internal control evaluation—receiving function)** Dunbar Camera Manufacturing, Inc. is a manufacturer of high-priced precision motion picture cameras in which the specifications of component parts are vital to the manufacturing process. Dunbar buys valuable camera lenses and large quantities of sheetmetal and screws. Screws and lenses are ordered by Dunbar and are billed by the vendors on a unit basis. Sheetmetal is ordered by Dunbar and billed by the vendors on the basis of weight. The receiving clerk is responsible for documenting the quality and quantity of merchandise received.

Your understanding of the internal control structure indicates that the following procedures are being followed:

1. *Receiving.* Information from properly approved purchase orders, which are prenumbered, is stored in the computer. The receiving clerk has access to all the information on the purchase order sent to the vendor. The receiving clerk records receipts of merchandise on a computer form that matches the purchase order.
2. *Sheetmetal.* The company receives sheetmetal by railroad. The railroad independently weighs the sheetmetal and reports the weight and date of receipt on a bill of lading (waybill), which accompanies all deliveries. The receiving clerk only checks the weight on the waybill against purchase order information in the computer.
3. *Screws.* The receiving clerk opens cartons containing screws, then inspects and weighs the contents. The weight is converted to number of units by means of conversion charts. The receiving clerk then compares the computed quantity to the purchase order information in the computer.
4. *Camera lenses.* Each camera lens is delivered in a separate corrugated carton. Cartons are counted as they are received by the receiving clerk, and the number of cartons is compared to purchase order information in the computer.

**Required**

- a. Explain why the internal control procedures as they apply individually to receiving reports and the receipts of sheetmetal, screws, and camera lenses are adequate or inadequate. Do not discuss recommendations for improvements.



- b. For inadequacies in internal controls describe the financial statement misstatements that may arise, and describe how they may occur.

AICPA (adapted)

- 15-26 **(Internal control evaluation—purchasing and cash disbursements)** In 20X4 XY Company purchased over \$10 million of office equipment under its “special” ordering systems, with individual orders ranging from \$5,000 to \$30,000. “Special” orders entail low-volume items that have been included in an authorized user’s budget. Department heads include in their annual budget requests the types and dollar amounts of office equipment and their estimated cost. The budget, which limits the types and dollar amounts of office equipment a department head can requisition, is approved at the beginning of the year by the board of directors. Department heads prepare a purchase requisition form for equipment and forward the requisition to the purchasing department. XY’s “special” ordering system functions as follows:

*Purchasing.* Upon receiving a purchase requisition, one of five buyers verifies that the person requesting the equipment is a department head. The buyer then selects the appropriate vendor by searching the various vendor catalogues on file. The buyer then phones the vendor, requesting a price quotation, and gives the vendor a verbal order. A prenumbered purchase order is then processed with the original sent to the vendor, and the purchase order information is stored in the computer and can be accessed by purchasing, receiving, and accounts payable. When the goods are received, the order is electronically transferred from the unfilled order file to the filled order file. Once a month the buyer reviews the unfilled order file to follow up and expedite open orders.

*Receiving.* The receiving department can access a copy of the purchase order. When equipment is received, the receiving clerk accesses the purchase order electronically and changes the purchase order for any difference between quantity on the purchase order and quantity received, which upon submission electronically becomes the receiving file. The computer system notifies the requisitioning department and purchasing department of the receipt.

*Accounts Payable.* The computer system maintains an open purchase order file. When a vendor’s invoice is received, the invoice is entered into the computer, matched with the applicable purchase order, and a payable is set up by debiting the equipment account of the department requesting the items. Unpaid invoices are electronically stored in an open invoice file that includes information on due dates. Daily a report is run of payables due by date, and at the due date a check is prepared. The vendor’s invoice is then filed with the purchase order in purchase order number in a paid invoice file, and the check is forwarded to the treasurer for signature.

*Treasurer.* Checks received daily from the accounts payable department are sorted into two groups—those greater than \$10,000 and those \$10,000 and less. Checks for \$10,000 and less are machine signed. The cashier maintains the key and signature plate to the check-signing machines, and maintains a record of usage of the check-signing machine. All checks over \$10,000 are signed by the treasurer or the controller.

### Required

Describe the internal control weaknesses relating to the purchases and payments of “special” orders of XY Company for each of the following functions:

- a. Purchasing
- b. Receiving
- c. Accounts payable
- d. Cash disbursements

- 15-27 **(Internal control evaluation—cash disbursements)** Management has requested a review of internal control over cash disbursements for parts and supplies purchased at manufac-

turing plants. Cash disbursements are centrally processed at corporate headquarters based on disbursement vouchers prepared and approved at the manufacturing plants. Each manufacturing plant purchases parts and supplies for its own production needs.

In response to management’s request, a thorough evaluation of internal control over disbursements for manufacturing plant purchases of parts and supplies is being planned. As a preliminary step in planning the engagement, each plant manager has been requested to provide a written description of his or her plant’s procedures for processing disbursement vouchers for parts and supplies. Presented below are some excerpts from one of the written descriptions.

1. The purchasing department acts on purchase requisitions issued by the stores department.
2. A computer system generates prenumbered purchase orders based on information submitted by buyers in purchasing.
3. Receiving has complete access to purchase order information in the computer.
4. When goods are received, the receiving department logs the shipment in the computer by indicating that the purchase order was received and forwards this electronically to accounts payable.
5. When the vendor invoice is received, it is entered into the computer and matched electronically with purchase order and receiving information. Discrepancies are printed on an exception report for followup by accounts payable personnel.
6. The computer checks the clerical accuracy of information on vendor invoices. Discrepancies are printed on an exception report for followup by accounts payable personnel.
7. A prenumbered disbursement is prepared and forwarded along with supporting documentation to the plant controller, who reviews and approves the voucher.
8. Supporting documents are returned to accounts payable for filing, and approved disbursement vouchers are forwarded to corporate headquarters for payment.
9. A report listing checks issued by corporate headquarters is received and promptly filed by accounts payable.

**Required**

For each of the disbursement system procedures listed above, state whether the procedure is consistent with good internal control and describe how each procedure strengthens or weakens internal control.

CONSISTENT/ INCONSISTENT	STRENGTHENS OR WEAKENS
1. (Example) Consistent	Purchase requisitions provide the authorization for purchasing to order.

- 15-28 **(Accounts payable assertions/confirmations)** Mincin, CPA, is the auditor of the Raleigh Corporation. Mincin is considering the audit work to be performed in the accounts payable area for the current year’s engagement. The prior year’s papers show that confirmation requests were mailed to 100 of Raleigh’s 1,000 suppliers. The selected suppliers were based on Mincin’s sample that was designed to select accounts with large dollar balances. A substantial number of hours were spent by Raleigh and Mincin resolving relatively minor differences between the confirmation replies and Raleigh’s accounting records. Alternative auditing procedures were used for those suppliers who did not respond to the confirmation requests.



**Required**

- a. Identify the accounts payable assertions that Mincin must consider in determining the substantive tests to be followed.
- b. Identify situations when Mincin should use accounts payable confirmations and discuss whether Mincin is required to use them.
- c. Discuss why the use of large dollar balances as the basis for selecting accounts payable for confirmation might not be the most efficient approach and indicate what more efficient procedures could be followed when selecting accounts payable for confirmation.

AICPA (adapted)

- 15-29 **(Search for unrecorded liabilities)** You were in the final stages of your audit of the financial statements of Ozine Corporation for the year ended December 31, 20X0, when you were consulted by the corporation's president, who believes there is no point in your examining the 20X1 voucher register and testing data in support of 20X1 entries. He stated that (a) bills pertaining to 20X0 that were received too late to be included in the December voucher register were recorded as of the year-end by the corporation by journal entry, (b) the internal auditor made tests after the year-end, and (c) he would furnish you with a letter certifying that there were no unrecorded liabilities.

**Required**

- a. Should a CPA's test for unrecorded liabilities be affected by the fact that the client made a journal entry to record 20X0 bills that were received late? Explain.
- b. Should a CPA's test for unrecorded liabilities be affected by the fact that a letter is obtained in which a responsible management official certifies that to the best of his knowledge all liabilities have been recorded? Explain.
- c. Should a CPA's test for unrecorded liabilities be eliminated or reduced because of the internal audit tests? Explain.
- d. Assume that the corporation, which handled some government contracts, had no internal auditor but that an auditor for a federal agency spent three weeks auditing the records and was just completing his work at this time. How would the CPA's unrecorded liability test be affected by the work of the auditor for a federal agency?
- e. What sources in addition to the 20X1 voucher register should the CPA consider to locate possible unrecorded liabilities?

AICPA

- 15-30 **(Substantive tests for accounts payable)** Taylor CPA is engaged in the audit of Rex Wholesaling for the year ended December 31, 20X2. Taylor performed a proper study of the internal control structure relating to the purchasing, receiving, trade accounts payable, and cash disbursement cycles, and has decided not to proceed with tests of controls. Based on analytical review procedures, Taylor believes that the trade accounts payable balance on the balance sheet as of December 31, 20X2 may be understated. Taylor requested and obtained a client-prepared trade accounts payable schedule listing the total amount owed to each vendor.

**Required**

What additional substantive auditing procedures should Taylor apply in auditing the trade accounts payable?

AICPA

## 15-31 (Understanding Internal Controls, Fraud Risk Assessment, and Substantive Tests)

## Phase I

## Company Background

Construction Industry Resources, Inc. (CIRI), a C Corporation, supplies building material to contractors and construction sites in a major metropolitan area. Today, CIRI has approximately \$60 million in total assets and generates approximately \$250 million in annual revenues. Les Browning, the majority shareholder, purchased CIRI five years ago when sales were approximately \$90 million per year and it was only in the building supply business. Les Browning owns 70 percent of CIRI, a business associate who is not active in the operation of the business owns 10 percent of the business, and two family members (Les Browning's father and his brother) own 10 percent each. The other shareholders hold management positions in other businesses (not in the construction industry) and are not active in day-to-day management. Five years ago Les owned only 55 percent of the business, and he purchased 5 percent from each of the other shareholders based on an independent valuation of the business two years ago. Eventually Les plans to purchase 100 percent of the common stock outstanding, sometime in the next five years. Les has prided himself on his ability to grow sales and profits of the company, and he looks forward to another 10 to 15 years of running the company, and enjoying the benefits of ownership, before considering an exit strategy and retirement.

The board of directors is composed of the four shareholders, a representative of CIRI's major lender, the corporation's attorney, and its controller, Craig Ferris. The board of directors meets semiannually to review the company's performance and make decisions regarding officer bonuses and dividends. Unlike public companies, CIRI does not have an audit committee. An audit is needed for the bank and other creditors, and the auditor meets annually with the board as a whole.

CIRI is composed of two major divisions; one division is involved in the purchase and sale of lumber, building materials, hardware, and related products. The other division is a lumber brokerage business. The building supply division competes in a very competitive business environment where business must be earned on both price competitiveness and on quality of service. The building supply division has three retail/wholesale outlets in a major metropolitan area of approximately 2 million people. The lumber brokerage business is also extremely price competitive. As a result, the company operates on relatively high ratios of sales to total assets (high asset turnover), and profit margins are low.

When Les Browning came to CIRI, he had a strong sales background and he focused first on customer relations and building sales in the building supply business, paying attention to CIRI's relationships with the major general contractors and builders in the community. Les knew that profit margins were going to be thin, so he focused his energies on growing sales volume. Then three years ago he decided to launch the lumber brokerage division, which allowed CIRI direct access to lumber markets as well as allowing the company to continue a strong growth trend in total revenues.

Craig Ferris has been CIRI's controller for 30 years, and he continued with the company when Les Browning and his other shareholders acquired it. Les Browning is comfortable with Craig's skills and knows that he will have to increase the salary for the position to hire a replacement when Craig retires. Craig, while not a CPA, has a competent understanding of GAAP and knows many of the suppliers and general contractors in the construction business. In addition to completing monthly income statements and balance sheets for the company, Craig has paid a great deal of attention in recent years to the lumber brokerage business, particularly understanding and attempting to control the business risks associated with price volatility in the lumber markets.

Craig also reviews each store's overall performance when the financial statements are prepared each month, but the company does not have sufficient staff or time to develop



budgets. Accountability for store performance is very informal. Store managers are paid competitive salaries, but they receive no bonuses. Hence, accounting numbers do not play in the determination of store managers' compensation packages. Furthermore, Craig Ferris and Les Browning feel that it would be too time consuming to develop budgets that reflect the seasonal nature of the business, and they feel that interim financial statements are sufficient to control the business.

You have been assigned to the audit of the building supplies division, specifically the purchases cycle, which consists primarily of the acquisition of inventories (many of which are delivered directly to building sites), the inventory cycle, and accounts payable.

### Analytical Procedures

The information needed for analytical procedures is provided in Question 15-22.

### Information and Communication and Control Activities

With respect to the accounting system and control activities, Les Browning has been rather hands off, focusing his attention on sales growth and lumber brokerage. He has been satisfied with Craig Ferris's ability to produce income numbers within 15 to 20 days after month-end, and he has relied on the annual audit to ensure that the accounting system is working correctly. In past audits, Les and Craig have accepted auditor-proposed journal entries related to the allowance for doubtful accounts and inventory shrinkage (a perpetual problem in the construction industry), but routine transactions have not resulted in significant audit problems. Three ongoing issues have been raised in prior management letters:

1. There is a segregation of duties problem in cash disbursements as Craig Ferris has access to the supply of unused checks, he signs checks, and performs the monthly bank reconciliations.
2. A similar segregation of duties issue has been raised regarding the activities of Wendy Roberts who authorizes credit, maintains accounts receivable records, and follows up on bad debts. However, Craig Ferris has responsibility for writing off bad debts.
3. There is no formal system and review associated with adding new vendors or new customers to master vendor and customer files.

Les Browning and other owners have not taken action on these issues because no significant audit adjustments have been proposed related to these problems. The owners have viewed the audit adjustments to the allowance for doubtful accounts as an issue where they welcome the oversight provided by outside auditors regarding an important accounting estimate.

The major change in the accounting system was planned last year and implemented at the beginning of the current year (20X5) when one of CIRI's major suppliers, Contractors Wholesale Supply (CWS), approached CIRI about implementing a purchasing system with electronic data interchange (EDI). Les Browning was eager to move forward with the system as it would keep CIRI on the cutting edge. In general, the EDI system allows CIRI to order goods electronically, CWS sends electronic sales invoices, and CIRI makes weekly payments by electronic funds transfer. Les Browning sees that the process will expedite shipments to customers, and CIRI would receive a 1 percent discount on all shipments ordered through the system. Craig Ferris was also willing to make the change since only modest computer programming changes were necessary at CIRI and a significant portion of the operating system was resident on the supplier's system.

Craig delegated implementation of the EDI system to Dennis Brewer. Dennis has been with the company for several years and has demonstrated strong technology skills. He was also responsible for accounts payable and accounting for inventories. Dennis looked at the systems project as a real opportunity to demonstrate his skills. Disappointed that he had not advanced faster in the organization, he had commented to colleagues about his frustration that most of his college friends had achieved management roles in their jobs, and they were earning good salaries and bonuses. Dennis has several children in private school

and felt that this was his opportunity to earn advancement, status, and the salary he wanted and needed.

Following is a brief description of how the new EDI purchasing system functions at CIRI:

**Initiating Purchases.** Several buyers are responsible for purchasing inventory, managing store inventories, and making sales to general contractors and the larger builders in the metropolitan area. The buyers determine inventory to order based on their review of inventory on hand and requests from customers. Based on perceived inventory needs, the buyer can log onto the CSW/CIRI system using passwords and electronically place a CIRI prenumbered purchase order directly with CWS on an on-line, real-time basis. CWS confirms the order electronically, and an electronic sales order is sent from CWS to Dennis Brewer. Dennis Brewer receives exception reports each morning of any mismatches between CIRI purchase orders and CWS sales orders. (CWS writes sales orders based on inventory that they have in stock.) Dennis tracks all purchases based on the prenumbered purchase orders. Buyers have restricted access to only the order side of the system (buyers can also monitor all inventory quantities). Receiving access has been given only to the warehouse clerks at each store. Dennis Brewer has full access to the system.

**Receiving Goods.** When shipments are received from CWS, they are counted by the warehouse clerk at each of CIRI's three stores. The clerk then logs into the CWS/CIRI and enters quantities received in the electronic equivalent of a prenumbered receiving report. The electronic receiving report is sent from each store to Dennis Brewer. Furthermore, approximately 35 percent of purchases are drop shipped directly to customer locations. In other words, a building contractor will call a CIRI buyer, who will order the goods from CWS and have them shipped directly to the building site. The warehouse clerk at each store has responsibility for following up on drop shipments with customers and filing electronic receiving reports for drop shipments. Experience shows that this is a low priority for these warehouse clerks, and it often takes nagging by Dennis Brewer each week to get these reports filed. This was a problem in the manual system in that on-site project managers were not good about signing delivery reports. When the warehouse clerk at the responsible store files an electronic receiving report for drop shipments, the clerk also has responsibility for filing a shipping report to initiate CIRI's customer billing process.

The receiving information updates the perpetual inventory records for all items received at one of the three stores. The perpetual inventory is not updated for drop shipments. The buyers informally review the accuracy of the perpetual inventory for reasonableness. A full physical inventory is done at year-end, and the stores are closed for that event.

**Recording Payables.** When CWS ships goods, an invoice is electronically sent to Dennis Brewer. Each day Dennis receives a computer-generated report of items that have been ordered from CWS, a report of items ordered that have not been received, and a list of all billings that have not been matched with prenumbered receiving reports. Dennis pays the most attention to these reports on Wednesdays and Thursdays so that all billings are cleared for electronic payment on Friday. He particularly follows up on items where electronic invoices have been received from CWS that have not yet been matched with receiving reports sent from the stores. He then files these exception reports by date with his notations on the various reports. Once the electronic receiving report is electronically matched with the sales invoice, a payable is established and Dennis Brewer approves payment of the invoice.

**Electronic Funds Transfer.** Every Friday, the total of approved invoices is paid via electronic funds transfer from CIRI to CWS. Craig Ferris is responsible for reviewing and approving a list of cash disbursements before they are run. With respect to the EDI system, Craig performs an overall reasonableness check on the volume of activity with CWS.

Craig Ferris feels that the system has greatly reduced the paperwork, made the office more efficient, and allowed the company to maintain margins in a very competitive marketplace. Dennis Brewer was happy to work on the project and was pleased to be given the



increased responsibility. However, Dennis was overheard in the lunchroom to have been disappointed that neither pay nor promotion advances were received as he expected, and that he is not earning what he deserves. Dennis expressed frustration that his career was going nowhere and that Craig Ferris and Les Browning were too tight fisted with promotion and recognition for the transition to go smoothly.

### Required

1. Evaluate the effectiveness of the CIRI's control environment. You may evaluate each individual component of the control environment, but then develop an overall conclusion regarding the control environment and its influence on other aspects of internal control.
2. Analytical procedures show that inventory turnover decreased from 31–34 days to 27 days, and gross margins declined to the lowest level in five years. What might this indicate about the risk of misstatement with respect to inventory and inventory purchases?
3. a. Using the table below, evaluate the factors associated with the risk of fraud and the effectiveness of control activities with respect to the existence and occurrence assertion associated with the EDI purchasing system.

<b>FRAUD RISK FACTORS</b>					
<b>ASSERTION</b>	<b>INCENTIVES/ PRESSURES</b>	<b>OPPORTUNITY</b>	<b>ATTITUDE &amp; RATIONALIZATION</b>	<b>CONTROL ACTIVITIES</b>	<b>POSSIBLE MISSTATEMENTS</b>
Existence and occurrence of purchases and payables					

- b. Identify reportable conditions that you might identify in the EDI purchasing system.
4. Prepare a letter with the two most important internal control recommendations that you have for management. Each specific recommendation should describe the current system, explain the risk involved, and make specific recommendations for improvement. Focus on issues raised by the new system and not on issues that have been raised in prior audits.

### Phase II

When obtaining an understanding of the accounting system, you looked at the file containing the exception reports reviewed by Dennis Brewer (e.g. for items billed but not received). While these reports are printed daily, often only three or four reports would be present for a given week. Dennis said that he really pays attention to the reports primarily on Wednesday and Thursday and that he often does not keep the reports from earlier in the week.

Subsequently, you pulled a sample of 30 transactions from the EDI system to perform substantive tests of transactions and test the accuracy of recording transactions that are processed through the system. Of the 30 transactions selected at random, 19 represented transactions shipped directly to stores, and 11 represented drop shipments. The following exhibit summarizes the nature of this sample of 30.

#### SUMMARY INFORMATION REGARDING SUBSTANTIVE TESTS OF TRANSACTIONS

	<b>\$ BV OF POPN.</b>	<b># OF TRANSACTIONS</b>	<b>SAMPLE SIZE</b>	<b>\$ BV OF SAMPLE</b>
Drop Shipments	\$ 5,756,077	1,391	11	\$ 80,530
Shipped to Stores	<u>\$ 10,615,018</u>	<u>1,737</u>	<u>19</u>	<u>\$ 188,455</u>
Purchases through the EDI System	<u>\$ 16,371,095</u>	<u>3,128</u>	<u>30</u>	<u>\$ 268,985</u>

You noted the following issues among the 30 transactions.

- You find one item that shipped directly to the stores with an invoice total of \$9,775 where one of the items on the invoice had a price per the purchase order of \$67 per unit and it was billed at \$76 per unit. The company purchased 100 units of the SKU number on that invoice and paid the invoice in full as billed.
- The company was closed from Thursday June 30, 20X5 through Monday, July 4, 20X5. Inventory was taken on Thursday, June 30, 20X5. During the inventory count, a truck came in with a shipment from BCWSC. The value of the invoice was \$9,875. The units were segregated from the rest of the inventory and not counted. At the end of the inventory, the shipment was added to the overall value of the inventory. During the closing of the books after July 4, the purchase was recorded as an accounts payable in the amount of \$9,875 with a date of June 30, 20X5.
- Auditing drop shipments has been a problem in past audits, as CIRI has not always had receiving documents to support deliveries to construction sites. However, your firm has been able to verify that shipments had been billed to customers, and subsequently cash was received associated with these deliveries. In the current year not only did you verify that the item was supported by electronic receiving reports, but you also followed up to find that they were billed to customers who paid for the goods. All 11 of the electronic invoices from BCWSC for drop shipments included in the sample were supported by electronic receiving reports, and they were paid in the correct amounts and on time. However, Dennis Brewer could not show where one transaction with an invoice amount of \$4,323 had been billed to, and had been paid by, customers. He suggested two possibilities. First, he suggested that some customers had prepaid for the shipments. Second, he complained that he often had to follow up with the stores about filing receiving reports because someone at the store level failed to file a shipping report. However, his primary responsibility was only for the purchasing system, not the billing system and ensuring that vendors were paid on time. He could not verify what caused the problem with this transaction. Further followup failed to identify the underlying sales invoice for this transaction.

**Required**

5. What concerns, if any, are raised by the evidence noted above? Assuming that the problems found in the sample are representative of problems in the population, determine any relevant amount of projected misstatement based on your finding assuming that the ratio of misstatements to book value found in the strata from which they were selected are representative of the entire strata. After considering your findings, what additional audit procedures should be performed, if any?
6. What issues do you want to discuss with management? Draft the issues that you want to discuss with company management, including who in management discussions should be held with.

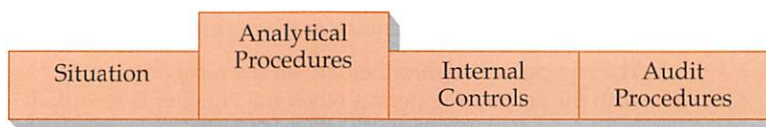
**professional simulations**

Situation	Analytical Procedures	Internal Controls	Audit Procedures
-----------	-----------------------	-------------------	------------------

You have just been assigned to the audit of a new manufacturing client, Carroll Manufacturing Inc. (CMI) and the in-charge accountant on the engagement. CMI manufactures automobile engines which are sold to several automotive companies. CMI purchases raw



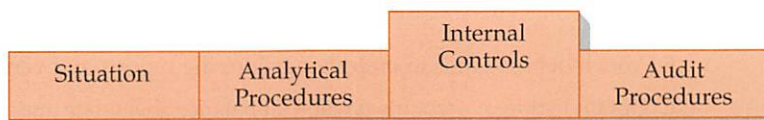
steel and cast iron. CMI does its own tool and die work, but it still purchases a number of parts related to carburetion and ignition systems.



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%	Sales Growth: 6% – 9%
	Accounts Payable Growth: 4%	Accounts Payable Growth: 6%–9%

The table above provides some preliminary information obtained during audit planning for CMI. Write a memo to the audit file explaining the planning implications associated with the audit findings above. Identify assertions that are likely to be overstated or understated.

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



*Assertion*

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

Identify the appropriate assertion for each of the following internal controls. Check all that apply.

<i>Internal Control</i>	(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 type="radio"/>
2. Only the controller and the assistant controller have the authority to add a new vendor to the vendor master file.	<input 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 type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

<i>Internal Control</i>	(A)	(B)	(C)	(D)	(E)
4. The manager of engine production reviews all purchases charged to his responsibility center on a weekly basis, reviewing vendors, amounts, and accounts charged.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
5. The computer matches the date on the receiving report with the accounting period when the voucher is recorded.	<input type="radio"/>	<input 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 type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

Situation	Analytical Procedures	Internal Controls	Audit Procedures
-----------	-----------------------	-------------------	------------------

*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.



