PART 4

APPLICATION OF THE AUDIT PROCESS TO OTHER CYCLES

CHAPTERS 18 – 23

Each chapter in **Part 4** demonstrates the relationship of internal controls, substantive tests of transactions, and analytical procedures to the related balance sheet and income statement accounts in the cycle and to test of details of balances.

- **Chapters 18 and 19** address the audit of the acquisition and payment cycle, including the audit of accounts payable and other liability accounts.
- **Chapter 20** addresses the audit of the inventory and warehousing cycle, including physical observation tests and the relationship of the inventory and warehousing cycle to other cycles.
- **Chapter 21** covers the audit of the payroll and personnel cycle.
- **Chapter 22** includes the audit of the capital acquisition and repayment cycle.
- **Chapter 23** is the audit of cash and investment balances, which is covered last because cash is affected by the transactions in other cycles.

CHAPTER 18

AUDIT OF THE ACQUISITION AND PAYMENT CYCLE: TESTS OF CONTROLS, SUBSTANTIVE TESTS OF TRANSACTIONS, AND ACCOUNTS PAYABLE

LEARNING OBJECTIVES

After studying this chapter, you should be able to

18-1 Identify the accounts and the classes of transactions in the acquisition and payment cycle.

18-2 Describe the business functions and the related documents and records in the acquisition and payment cycle.

18-3 Understand internal control, and design and perform tests of controls and substantive tests of transactions for the acquisition and payment cycle.

18-4 Describe the methodology for designing tests of details of balances for accounts payable using the audit risk model.

18-5 Design and perform analytical procedures for accounts payable.

18-6 Design and perform tests of details of balances for accounts payable, including out-of-period liability tests.

18-7 Distinguish the reliability of vendors' invoices, vendors' statements, and confirmations of accounts payable as audit evidence.

False Purchases Camouflage Overstated Profits

Comptronix Corporation announced that senior members of its management team overstated profits, and there would be material adjustments to the prior years' audited financial statements. Central to the fraud was the use of fictitious purchases of large equipment items to overstate fixed assets and hide fictitious sales.

The senior executives circumvented Comptronix's existing internal controls by bypassing the purchasing and receiving departments so that no one at Comptronix could discover the scheme. Comptronix employees usually created a fairly extensive paper trail for equipment purchases. Company internal controls over acquisition and cash disbursement transactions typically required a purchase order, receiving report, and vendor invoice before payment could be authorized by the chief operating officer or the controller/treasurer, who were both participants in the fraud. As a result, the executives were able to bypass controls over cash disbursements and authorize payment for nonexistent purchases without creating any documents for the fictitious transactions.

The company also created fictitious sales and related receivables. The company issued checks to pay for the false purchase transactions. The checks were then redeposited into the company's bank account and recorded as collections on the fictitious receivables. As a result, it appeared that the fictitious sales were collected, and that payments were made to support the false fixed asset purchases.

The fraud scheme grossly exaggerated the company's performance by reporting profits when the company was actually incurring losses. On the day that the public announcement of the fraud was made, Comptronix's common stock price declined abruptly by 72 percent! The SEC ultimately charged the executives with violating the antifraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934. The SEC permanently barred the executives from serving as officers or directors of any public company, ordered them to repay bonuses and trading losses avoided, and imposed civil monetary penalties against them.

Source: Based on *Accounting and Auditing Enforcement Release No. 543*, Commerce Clearing House, Inc., Chicago.

We'll now discuss the **acquisition and payment cycle**. The acquisition of goods and services includes the acquisition of such things as raw materials, equipment, supplies, utilities, repairs and maintenance, and research and development. In the first part of the chapter, we'll examine assessing control risk and designing tests of controls and substantive tests of transactions for the classes of transactions in the acquisition and payment cycle. Then, we'll cover performing tests of details of balances for accounts payable.

As with the sales and collection cycle, auditors need to understand the business functions and documents and records in a company before they can assess control risk and design tests of controls and substantive tests of transactions. We first examine two related topics:

1. The acquisition and payment cycle classes of transactions and account balances in a typical company
2. Typical documents and records used in the acquisition and payment cycle

ACCOUNTS AND CLASSES OF TRANSACTIONS IN THE ACQUISITION AND PAYMENT CYCLE

OBJECTIVE 18-1

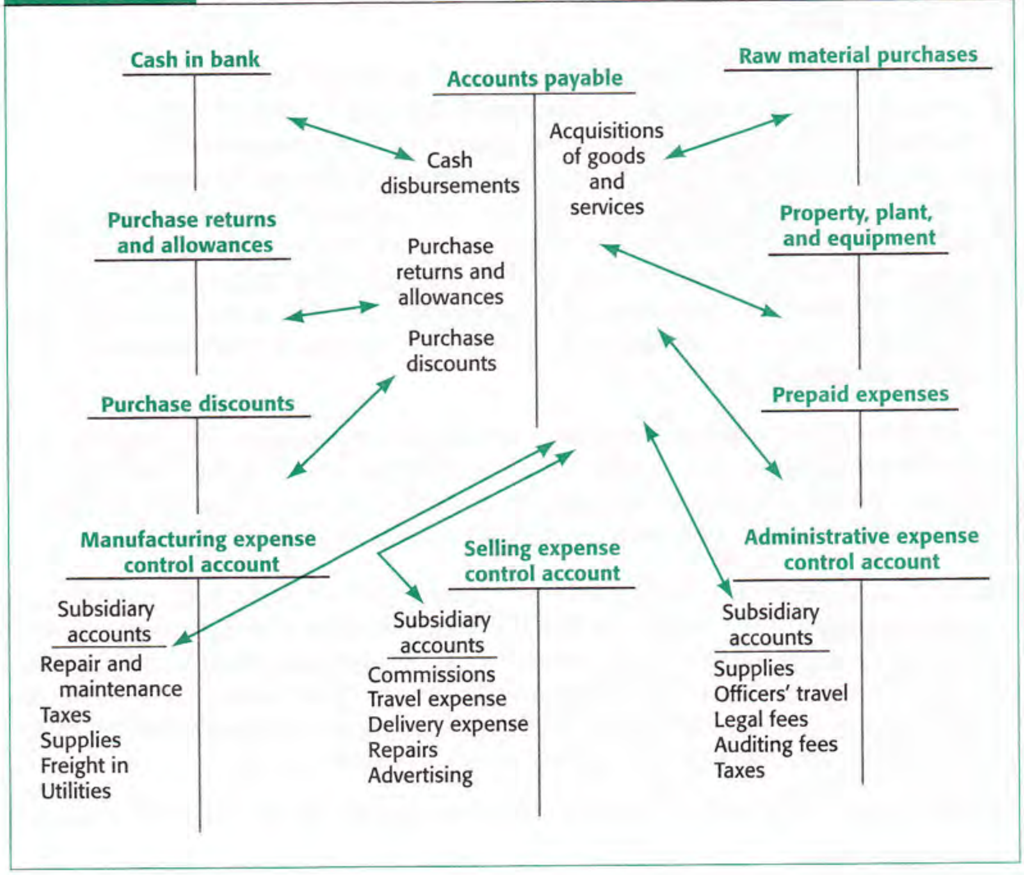
Identify the accounts and the classes of transactions in the acquisition and payment cycle.

The objective in the audit of the acquisition and payment cycle is to evaluate whether the accounts affected by the acquisitions of goods and services and the cash disbursements for those acquisitions are fairly presented in accordance with accounting standards. Figure 18-1 shows the way accounting information flows through the various accounts in the acquisition and payment cycle.

There are three classes of transactions included in the cycle:

1. Acquisitions of goods and services
2. Cash disbursements
3. Purchase returns and allowances and purchase discounts

FIGURE 18-1 **Accounts in the Acquisition and Payment Cycle**



Ten typical accounts involved in the acquisition and payment cycle are shown by T accounts in Figure 18-1. For simplicity, we show only the control accounts for the three major categories of expenses used by most companies. For each control account, examples of the subsidiary expense accounts are also given. Note the large number of accounts affected by this cycle. It is therefore not surprising that auditing the acquisition and payment cycle often takes more time than any other cycle.

Figure 18-1 shows that every transaction is either debited or credited to accounts payable. Because some companies make acquisitions directly by check or with cash on hand, the figure is an oversimplification. We assume that acquisitions made for cash are processed in the same manner as those made by accounts payable.

BUSINESS FUNCTIONS IN THE CYCLE AND RELATED DOCUMENTS AND RECORDS

OBJECTIVE 18-2

Describe the business functions and the related documents and records in the acquisition and payment cycle.

The acquisition and payment cycle involves the decisions and processes necessary for obtaining the goods and services for operating a business. The cycle typically begins with the initiation of a purchase requisition by an authorized employee who needs the goods or services, and it ends with payment on accounts payable. In the following discussion, the example of a small manufacturing company that makes tangible products for sale to third parties is used, but the principles covered here also apply to service companies, government entities, and other types of organizations.

The third column of Table 18-1 (p. 616) lists four business functions that occur in every business in recording the three classes of transactions in the acquisition and payment cycle. The first three functions are for recording the acquisition of goods and services on account, and the fourth function is for recording cash disbursements for payments to vendors. For simplicity, our illustration does not show processing purchase returns and allowances and purchase discounts. Although purchase returns and allowances and purchase discounts business functions also occur in this cycle, we omit them here because the amounts are not significant for most companies.

Next, we examine in more detail each of the four business functions, paying particular attention to the typical documents and records used. These are listed in the fourth column of Table 18-1.

Processing Purchase Orders

The request for goods or services by the client's personnel is the starting point for the cycle. The exact form of the request and the required approval depend on the nature of the goods and services and company policy. Common documents include:

Purchase Requisition A **purchase requisition** is used to request goods and services by an authorized employee. This may take the form of a request for such acquisitions as materials by production staff or the storeroom supervisor, outside repairs by office or plant personnel, or insurance by the vice president in charge of property and equipment. Companies often rely on pre-specified reorder points used by the computer to initiate inventory purchase requisitions automatically.

Purchase Order A **purchase order** is a document used to order goods and services from vendors. It includes the description, quantity, and related information for goods and services the company intends to purchase and is often used to indicate authorization of the acquisition. Companies often submit purchase orders electronically to vendors who have made arrangements for electronic data interchange (EDI).

Receiving Goods and Services

The receipt by the company of goods or services from the vendor is a critical point in the cycle because it is when most companies first recognize the acquisition and related liability on their records. When goods are received, adequate control requires examination for description, quantity, timely arrival, and condition. A **receiving report** is a paper or electronic document prepared at the time goods are received.

TABLE 18-1 **Classes of Transactions, Accounts, Business Functions, and Related Documents and Records for the Acquisition and Payment Cycle**

Classes of Transactions	Accounts	Business Functions	Documents and Records
Acquisitions	Inventory Property, plant, and equipment Prepaid expenses	Processing purchase orders	Purchase requisition Purchase order
	Leasehold improvements	Receiving goods and services	Receiving report
	Accounts payable Manufacturing expenses Selling expenses Administrative expenses	Recognizing the liability	Vendor's invoice Debit memo Voucher Acquisitions transaction file Acquisitions journal or listing Accounts payable master file Accounts payable trial balance Vendor's statement
Cash disbursements	Cash in bank (from cash disbursements) Accounts payable Purchase discounts	Processing and recording cash disbursements	Check or electronic payment Cash disbursements transaction file Cash disbursements journal or listing

It includes a description of the goods, the quantity received, the date received, and other relevant data.

Recognizing the Liability

The proper recognition of the liability for the receipt of goods and services requires *prompt and accurate* recording. The initial recording affects the financial statements and the actual cash disbursement; therefore, companies must take care to include all acquisition transactions, only acquisitions that occurred, and at the correct amounts. Common documents and records include:

Vendor's Invoice A **vendor's invoice** is a document received from the vendor and shows the amount owed for an acquisition. It indicates the description and quantity of goods and services received, price (including freight), cash discount terms, date of the billing, and total amount. The vendor's invoice is important because it indicates the amount recorded in the acquisition transaction file. For companies using EDI, the vendor's invoice is transmitted electronically, which affects how the auditor evaluates evidence.

Debit Memo A **debit memo** is also a document received from the vendor and indicates a reduction in the amount owed to a vendor because of returned goods or an allowance granted. It often takes the same form as a vendor's invoice, but it supports reductions in accounts payable rather than increases.

Voucher A **voucher** is commonly used by organizations to establish a formal means of recording and controlling acquisitions, primarily by enabling each acquisition transaction to be sequentially numbered. Vouchers include a cover sheet or folder for containing documents and a package of relevant documents such as the purchase order, copy of the packing slip, receiving report, and vendor's invoice. After payment, a copy of the check or electronic funds transfer is added to the voucher package.

Acquisitions Transaction File This is a computer-generated file that includes all acquisition transactions processed by the accounting system for a period, such as a day, week, or month. It contains all information entered into the system and includes information for each transaction, such as vendor name, date, amount, account classification or classifications, and description and quantity of goods and services purchased. The file can also include purchase returns and allowances or there can be a separate file for those transactions. Depending on the company's needs, the information in the acquisitions transaction file is used for a variety of records, listings, or reports, such as an acquisitions journal, accounts payable master file, and transactions for a certain account balance or division.

Acquisitions Journal or Listing The **acquisitions journal** or listing, often referred to as the purchases journal, is generated from the acquisitions transaction file and typically includes the vendor name, date, amount, and account classification or classifications for each transaction, such as repair and maintenance, inventory, or utilities. It also identifies whether the acquisition was for cash or accounts payable. The journal or listing can cover any time period, typically a month. The journal or listing includes totals of every account number included for the time period. The same transactions included in the journal or listing are also posted simultaneously to the general ledger and, if they are on account, to the accounts payable master file.

Accounts Payable Master File An **accounts payable master file** records acquisitions, cash disbursements, and acquisition returns and allowances transactions for each vendor. The master file is updated from the acquisition, returns and allowances, and cash disbursement computer transaction files. The total of the individual account balances in the master file equals the total balance of accounts payable in the general ledger. A printout of the accounts payable master file shows, by vendor, the beginning balance in accounts payable, each acquisition, acquisition return and allowance, cash disbursement, and the ending balance. Many companies do not maintain an accounts payable master file by vendor. These companies pay on the basis of individual vendor's invoices. Therefore, the total of unpaid vendors' invoices in the master file equals total accounts payable.

Accounts Payable Trial Balance An **accounts payable trial balance** listing includes the amount owed to each vendor or for each invoice or voucher at a point in time. It is prepared directly from the accounts payable master file.

Vendor's Statement A **vendor's statement** is a document prepared monthly by the vendor and indicates the beginning balance, acquisitions, returns and allowances, payments to the vendor, and ending balance. These balances and activities are the vendor's representations of the transactions for the period, not the client's. Except for disputed amounts and timing differences, the client's accounts payable master file should be the same as the vendor's statement.

Processing and Recording Cash Disbursements

The payment for goods and services represents a significant activity for all entities. This activity directly reduces balances in liability accounts, particularly accounts payable. Documents associated with the disbursement process that auditors examine include:

Check This document is commonly used to pay for the acquisition when payment is due. Most companies use computer-prepared checks based on information included in the acquisition transactions file at the time goods and services are received. Checks are typically prepared in a multi-copy format, with the original going to the payee, one copy filed with the vendor's invoice and other supporting documents, and another filed numerically. In most cases, individual checks are recorded in a cash disbursements transaction file.

After a check includes the signature of an authorized person, it is an asset. Therefore, signed checks should be mailed by the signer or a person under the signer's control. When cashed by the vendor and cleared by the client's bank, it is called a cancelled check. At that point it is no longer an asset, but now is a document. In many EDI arrangements, the company submits payments to the vendor electronically through an electronic funds transfer (EFT) between the company's bank and the vendor's bank.

Cash Disbursements Transaction File This is a computer-generated file that includes all cash disbursements transactions processed by the accounting system for a period, such as a day, week, or month. It includes the same type of information discussed for the acquisitions transaction file.

Cash Disbursements Journal or Listing This is a listing or report generated from the cash disbursements transaction file that includes all transactions for any time period. The same transactions, including all relevant information, are included in the accounts payable master file and general ledger.

METHODOLOGY FOR DESIGNING TESTS OF CONTROLS AND SUBSTANTIVE TESTS OF TRANSACTIONS

OBJECTIVE 18-3

Understand internal control, and design and perform tests of controls and substantive tests of transactions for the acquisition and payment cycle.

In a typical audit, the most time-consuming accounts to verify by substantive tests of details of balances are accounts receivable, inventory, fixed assets, accounts payable, and expense accounts. Notice that four of these five are directly related to the acquisition and payment cycle. If the auditor can reduce tests of details of the account balances by using tests of controls and substantive tests of transactions to verify the effectiveness of internal controls for acquisitions and cash disbursements, the net time saved can be dramatic. Tests of controls and substantive tests of transactions for the acquisition and payment cycle receive a considerable amount of attention, especially when the client has effective internal controls.

Tests of controls and substantive tests of transactions for the acquisition and payment cycle are divided into two broad areas:

1. Tests of acquisitions, which concern three of the four business functions discussed earlier in this chapter: processing purchase orders, receiving goods and services, and recognizing the liability
2. Tests of payments, which concern the fourth function, processing, and recording cash disbursements

Figure 18-2 illustrates the methodology for designing tests of controls and substantive tests of transactions for the acquisition and payment cycle. It is the same methodology used in earlier chapters. Next, let's examine each part of Figure 18-2, starting with understanding internal control.

Understand Internal Control

The auditor gains an understanding of internal control for the acquisition and payment cycle as part of performing risk assessment procedures by studying the client's flowcharts, reviewing internal control questionnaires, and performing walkthrough tests for acquisition and cash disbursement transactions. The procedures for understanding internal control in the acquisition and payment cycle are similar to the procedures performed in other transaction cycles, as discussed in earlier chapters.

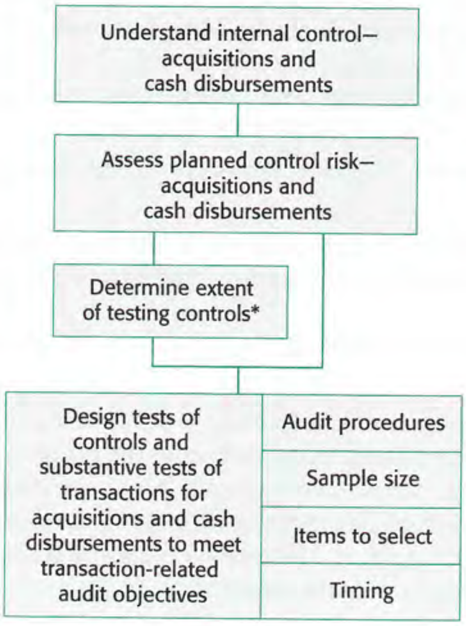
Assess Planned Control Risk

Next, the key internal controls for each of the business functions described earlier in this chapter are examined. These are authorization of purchases, separation of the custody of the received goods from other functions, timely recording and independent review of transactions, and authorization of payments to vendors.

Authorization of Purchases Proper authorization for acquisitions ensures that the goods and services acquired are for authorized company purposes, and it avoids the acquisition of excessive or unnecessary items. Most companies require different levels of authorization for different types of acquisitions or dollar amounts. For example, acquisitions of fixed assets in excess of a specified dollar limit require approval by the board of directors; items acquired relatively infrequently, such as insurance policies and long-term service contracts, are approved by certain officers; supplies and services costing less than a designated amount are approved by supervisors and department heads; and some types of raw materials and supplies are reordered automatically when they fall below a predetermined level, often by direct communication with vendors' computers.

After the purchase requisition for an acquisition has been approved, a purchase order to acquire the goods or services must be initiated. A purchase order is issued

FIGURE 18-2 **Methodology for Designing Tests of Controls and Substantive Tests of Transactions for the Acquisition and Payment Cycle**



* Extent of testing of controls is determined by planned reliance on controls. For accelerated filer public companies, testing must be sufficient to issue an opinion on internal control over financial reporting.

to a vendor for a specified item at a certain price to be delivered at or by a designated time. The purchase order, issued either in written or electronic form, is generally viewed as a legal document, and represents an offer to buy the goods or services.

Companies commonly establish purchasing departments to ensure an adequate quality of goods and services at a minimum price. For effective internal control, the purchasing department should be separate from those who authorize the acquisition or receive the goods. All purchase orders should be prenumbered to permit easier accounting for all outstanding purchases orders and should be designed to minimize the likelihood of unintentional omissions on the form when goods are ordered.

Separation of Asset Custody from Other Functions Most companies have the receiving department initiate a receiving report as evidence of the receipt and examination of goods. One copy is normally sent to the raw materials storeroom and another to the accounts payable department for their information needs. To prevent theft and misuse, the goods should be *physically controlled* from the time of their receipt until their use or disposal. The personnel in the receiving department should be independent of the storeroom personnel and the accounting department. Finally, the accounting records should transfer responsibility for the goods each time they are moved, from receiving to storage, from storage to manufacturing, etc.

Timely Recording and Independent Review of Transactions In some companies, the recording of the liability for acquisitions is made on the basis of the receipt of goods and services. In others, recording is deferred until the vendor's invoice is received. In either case, the accounts payable department typically has responsibility for verifying the appropriateness of acquisitions. This is done by comparing the details on the purchase order, the receiving report, and the vendor's invoice to determine that the descriptions, prices, quantities, terms, and freight on the vendor's invoice are correct. Typically, the accounts payable department also verifies extensions, footings, and account distributions. In some cases, computer software matches documents and verifies invoice accuracy automatically. The accounts payable department should also account for all receiving reports to assure that the completeness objective is satisfied.

An important control in the accounts payable and information technology departments is the requirement that personnel who record acquisitions do not have access to cash, marketable securities, and other assets. Adequate documents and records, proper procedures for record keeping, and independent checks on performance are also necessary controls in the accounts payable function.

Authorization of Payments The most important controls over cash disbursements include:

- The signing of checks by an individual with proper authority
- Separation of responsibilities for signing checks and performing the accounts payable function
- Careful examination of supporting documents by the check signer at the time the check is signed

The checks should be prenumbered to make it easier to account for all checks and printed on special paper that makes it difficult to alter the payee or amount. Companies should take care to provide physical control over blank, voided, and signed checks. They should also have a method of canceling supporting documents to prevent their reuse as support for another check at a later time. A common method is to document the check number on the supporting documents.

Determine Extent of Testing of Controls

After auditors identify key internal controls and deficiencies, they assess control risk. When auditors intend to rely on controls to support a preliminary control risk assessment below maximum, the auditor performs tests of controls to obtain evidence that controls are operating effectively. As the operating effectiveness of controls improves and is supported by additional tests of controls, the auditor is able to reduce substantive testing. Of course, if the client is an accelerated filer public company, the auditor must document and test controls sufficiently to issue an opinion on internal control over financial reporting.

Design Tests of Controls and Substantive Tests of Transactions for Acquisitions

Table 18-2 summarizes key internal controls, common tests of controls, and common substantive tests of transactions for each transaction-related audit objective. We assume the existence of a separate acquisitions journal or listing for recording all acquisitions.

As you examine Table 18-2, you should:

- Relate each of the internal controls to transaction-related audit objectives
- Relate tests of controls to internal controls
- Relate substantive tests of transactions to transaction-related audit objectives after considering controls and deficiencies in the system

The audit evidence for an audit engagement will vary with the internal controls and other circumstances. Significant audit efficiencies can be achieved on many audits when controls are operating effectively.

APPLE MANAGER ACCUSED OF RECEIVING KICKBACKS RELATED TO iPHONE AND iPOD

An Apple Computer manager was accused of receiving over $1 million in kickbacks from Asian suppliers of iPhone and iPod accessories. The manager transmitted confidential information to the suppliers, which allowed them to negotiate favorable contracts with Apple.

The alleged scheme involved a chain of U.S. and foreign bank accounts, as well as a front company to receive payments. The manager reportedly opened bank accounts in several countries in Asia to receive the kickbacks, and also received payments directly when traveling to Asia. The payments were referred to by code words such as "sample" to avoid detection by co-workers.

Source: Based on Pete Carey, "Apple Manager Indicted in Kickback Scheme," *San Jose Mercury News*, August 13, 2010 (www.mercurynews.com).

TABLE 18-2 **Summary of Transaction-Related Audit Objectives, Key Controls, Tests of Controls, and Substantive Tests of Transactions for Acquisitions**

Transaction-Related Audit Objectives	Key Internal Controls	Common Tests of Controls	Common Substantive Tests of Transactions
Recorded acquisitions are for goods and services received, consistent with the best interests of the client (occurrence).	Purchase requisition, purchase order, receiving report, and vendor's invoice are attached to the voucher.* Acquisitions are approved at the proper level. Computer accepts entry of purchases only from authorized vendors in the vendor master file. Documents are cancelled to prevent their reuse. Vendors' invoices, receiving reports, purchase orders, and purchase requisitions are internally verified.*	Examine documents in voucher package for existence. Examine indication of approval. Attempt to input transactions with valid and invalid vendors. Examine indication of cancellation. Examine indication of internal verification.	Review the acquisitions journal, general ledger, and accounts payable master file for large or unusual amounts.† Examine underlying documents for reasonableness and authenticity (vendors' invoices, receiving reports, purchase orders, and purchase requisitions).* Examine vendor master file for unusual vendors. Trace inventory acquisitions to inventory master file. Examine fixed assets acquired.
Existing acquisition transactions are recorded (completeness).	Purchase orders are prenumbered and accounted for. Receiving reports are prenumbered and accounted for.* Vouchers are prenumbered and accounted for.	Account for a sequence of purchase orders. Account for a sequence of receiving reports. Account for a sequence of vouchers.	Trace from a file of receiving reports to the acquisitions journal.* Trace from a file of vendors' invoices to the acquisitions journal.
Recorded acquisition transactions are accurate (accuracy).	Calculations and amounts are internally verified. Batch totals are compared with computer summary reports. Acquisitions are approved for prices and discounts.	Examine indication of internal verification. Examine file of batch totals for initials of data control clerk; compare totals to summary reports. Examine indication of approval.	Compare recorded transactions in the acquisitions journal with the vendor's invoice, receiving report, and other supporting documentation.* Recompute the clerical accuracy on the vendor's invoice, including discounts and freight.
Acquisition transactions are correctly included in the accounts payable and inventory master files and are correctly summarized (posting and summarization).	Accounts payable master file contents are internally verified. Accounts payable master file or trial balance totals are compared with general ledger balances.	Examine indication of internal verification. Examine initials on general ledger accounts indicating comparison.	Test clerical accuracy by footing the journals and tracing postings to general ledger and accounts payable and inventory master files.
Acquisition transactions are correctly classified (classification).	An adequate chart of accounts is used. Account classifications are internally verified.	Examine procedures manual and chart of accounts. Examine indication of internal verification.	Compare classification with chart of accounts by referring to vendors' invoices.
Acquisition transactions are recorded on the correct dates (timing).	Procedures require recording transactions as soon as possible after the goods and services have been received. Dates are internally verified.	Examine procedures manual and observe whether unrecorded vendors' invoices exist. Examine indication of internal verification.	Compare dates of receiving reports and vendors' invoices with dates in the acquisition journal.*

*Receiving reports are used only for tangible goods and are therefore not used for services, such as utilities and repairs and maintenance. Often, vendors' invoices are the only documentation available.

†This analytical procedure can also apply to other objectives, including completeness, accuracy, and timing.

Four of the six transaction-related audit objectives for acquisitions deserve special attention and are therefore examined more closely. The correctness of many asset, liability, and expense accounts depends on the correct recording of transactions in the acquisitions journal, especially related to these four objectives.

1. Recorded Acquisitions Are for Goods and Services Received, Consistent with the Best Interests of the Client (Occurrence) If the auditor is satisfied that the controls are adequate for this objective, tests for improper transactions and recorded transactions that did not occur can be greatly reduced. Adequate controls prevent the unintentional recording of acquisitions that did not occur, especially recording duplicate acquisitions. Adequate controls are also likely to prevent the client from including as a business expense or asset fraudulent transactions or those that primarily benefit management or other employees rather than the entity being audited. In some instances, improper transactions are obvious, such as the acquisition of unauthorized personal items by employees. In other instances, the appropriateness of a transaction is more difficult to evaluate, such as the payment of officers' memberships to country clubs or expense-paid vacations to foreign countries for management and their families. If the controls over improper transactions or transactions that did not occur are inadequate, more extensive examination of supporting documentation is necessary.

2. Existing Acquisitions Are Recorded (Completeness) Failure to record the acquisition of goods and services received understates accounts payable and may result in an overstatement of net income and owners' equity. Therefore, auditors consider this an essential objective for acquisitions. It may be difficult in some audits to perform tests of details of balances to determine whether unrecorded transactions exist, so the auditor must rely on controls and substantive tests of transactions for this purpose. In addition, because the audit of accounts payable usually takes considerable time, effective internal controls, properly tested, can significantly reduce audit costs.

3. Acquisitions Are Accurately Recorded (Accuracy) The extent of tests of details of many balance sheet and expense accounts depends on the auditor's evaluation of the effectiveness of the internal controls over the accuracy of recorded acquisition transactions. For example, if the auditor believes that the fixed asset transactions are correctly recorded in the acquisitions journal, it is acceptable to vouch fewer current period acquisitions during tests of details of balances than if the controls are inadequate.

When a client uses perpetual inventory records, tests of details of inventory can also be significantly reduced if the auditor believes the perpetual records are accurate. The controls over acquisitions included in the perpetual records are normally tested as a part of the tests of controls and substantive tests of transactions for acquisitions.

4. Acquisitions Are Correctly Classified (Classification) Tests of details of certain individual accounts can be reduced if the auditor believes that internal controls are adequate to provide reasonable assurance of correct classification in the acquisitions journal. Although all accounts are affected to some degree by effective controls over classification, the two areas most affected are current period acquisitions of fixed assets, and all expense accounts, such as repairs and maintenance, utilities, and advertising.

It is relatively time-consuming for auditors to perform documentation tests of current period fixed asset acquisitions and expense accounts for accuracy and classification. Therefore, time-savings can be significant when controls are effective.

Design Tests of Controls and Substantive Tests of Transactions for Cash Disbursements

Table 18-3 for cash disbursements uses the same format as Table 18-2 (p. 621) for acquisitions. We assume for these controls and audit procedures that separate cash disbursements and acquisitions journals exist. Our comments about the methodology and process for developing audit procedures for acquisitions apply equally to cash disbursements.

Auditors typically perform the acquisitions and cash disbursements tests at the same time. For a transaction selected for examination from the acquisitions journal,

TABLE 18-3	Summary of Transaction-Related Audit Objectives, Key Controls, Tests of Controls, and Substantive Tests of Transactions for Cash Disbursements		
Transaction-Related Audit Objectives	**Key Internal Controls**	**Common Tests of Controls**	**Common Substantive Tests of Transactions**
Recorded cash disbursements are for goods and services actually received (occurrence).	There is adequate segregation of duties between accounts payable and custody of signed checks or authority to disburse funds electronically. Supporting documentation is examined before signing of checks or electronic disbursement of funds by an authorized person. Approval of payment on supporting documents is given at the time checks are signed.	Discuss with personnel and observe activities. Discuss with personnel and observe activities. Examine indication of approval.	Review the cash disbursements journal, general ledger, and accounts payable master file for large or unusual amounts.* Trace the cancelled check or electronic bank records of disbursements to the related acquisitions journal entry and examine for payee name and amount. Examine cancelled check for authorized signature, proper endorsement, and cancellation by the bank or use bank records to verify payee for electronic payments. Examine supporting documents as part of the tests of acquisitions.
Existing cash disbursement transactions are recorded (completeness).	Checks are prenumbered and accounted for. The bank reconciliation is prepared monthly by an employee independent of recording cash disbursements or custody of assets.	Account for a sequence of checks. Examine bank reconciliations and observe their preparation.	Reconcile recorded cash disbursements with the cash disbursements on the bank statement (proof of cash disbursements).
Recorded cash disbursement transactions are accurate (accuracy).	Calculations and amounts are internally verified. The bank reconciliation is prepared monthly by an independent person.	Examine indication of internal verification. Examine bank reconciliations and observe their preparation.	Compare cancelled checks and electronic bank records of disbursements with the related acquisitions journal and cash disbursements journal entries. Recompute cash discounts. Prepare a proof of cash disbursements.
Cash disbursement transactions are correctly included in the accounts payable master file and are correctly summarized (posting and summarization).	Accounts payable master file contents are internally verified. Accounts payable master file or trial balance totals are compared with general ledger balances.	Examine indication of internal verification. Examine initials on general ledger accounts indicating comparison.	Test clerical accuracy by footing journals and tracing postings to general ledger and accounts payable master file.
Cash disbursement transactions are correctly classified (classification).	An adequate chart of accounts is used. Account classifications are internally verified.	Examine procedures manual and chart of accounts. Examine indication of internal verification.	Compare classification with chart of accounts by referring to vendors' invoices and acquisitions journal.
Cash disbursement transactions are recorded on the correct dates (timing).	Procedures require recording of transactions as soon as possible after the check has been signed or electronically submitted for bank processing. Dates are internally verified.	Examine procedures manual and observe whether unrecorded checks exist. Examine indication of internal verification.	Compare dates on cancelled checks or electronic bank records with the cash disbursements journal. Compare dates on cancelled checks or electronic bank records with the bank cancellation date.

*This analytical procedure can also apply to other objectives, including completeness, accuracy, and timing.

DEFICIENT INTERNAL CONTROLS OVER DISBURSEMENTS LEADS TO $2.2 EMBEZZLEMENT

Just after the abrupt resignation of the treasurer at Dallas-based U.S. Lime & Minerals, Inc., auditors on Ernst & Young's engagement team discovered what appeared to be a significant embezzlement of company funds by the high-ranking financial officer. Subsequent investigation by the Securities and Exchange Commission (SEC) led to allegations that Larry T. Ohms, U.S. Lime's vice president of finance and treasurer, had embezzled nearly $2.2 million by circumventing internal controls over cash disbursements over a four-year period.

According to the SEC's investigation, Ohms initiated his embezzlement activities in January 1998, which ultimately involved over 100 separate fraudulent disbursements by December 2001. Ohms stole funds from the company by misusing company checks, with individual thefts ranging from $2,000 to $100,000. The fraud amounts increased each year: $126,000 in 1998; $282,000 in 1999; $729,000 in 2000; and $980,000 in 2001.

To conceal his efforts, he used a variety of fraud scam techniques. In some instances, he issued checks to himself, stamped his signature and the CEO's signature on the check using signature plates from a mechanical check-signing machine, and recorded the disbursements as payments to a law firm that provided legal services to U.S. Lime. Other disbursements paid to him were disguised as payments for worker's compensation insurance premiums. He then began to forge the signature of another corporate officer on reimbursement checks to Ohms for fake business expenses. In 2000, he used "counter" checks and "starter" checks that U.S. Lime received when it opened a new bank account with a different bank. He made the checks payable to the bank and then exchanged them for bank cashier checks made payable to his personal creditors. For some of those transactions, he forged other officers' signatures, while in other instances the bank accepted checks with only Ohms' signature. To cover his tracks, he recorded these disbursements as "prepaid financing costs," which were reported as assets on U.S. Lime's balance sheet.

Ohms was later convicted of the embezzlement and sentenced to 32 months in federal prison, plus three years of supervised release, and was ordered to pay $2,179,195 in restitution to U.S. Lime. He was also permanently barred from serving as an officer or director of a public company again.

Sources: 1. "Securities and Exchange Commission v. Larry T. Ohms, Case No.: 3:02-CV-2361-D, United States District Court for the Northern District of Texas," October 29, 2002 (www.sec.gov); 2. SEC Litigation Release No. 18053, "United States v. Larry T. Ohms," March 28, 2003 (www.sec.gov).

the vendor's invoice, receiving report, and other acquisition documentation are examined at the same time as the related cancelled check. Thus, the verification is done efficiently without reducing the effectiveness of the tests.

Attributes Sampling for Tests of Controls and Substantive Tests of Transactions

Because of the importance of tests of controls and substantive tests of transactions for acquisitions and cash disbursements, the use of attributes sampling is common. The approach is similar to that used for the tests of controls and substantive tests of transactions for sales discussed in the "Statistical Audit Sampling" section on page 518 of Chapter 15.

There are three important differences in acquisitions and payments compared to other cycles.

1. As discussed in the beginning of the chapter, there are a larger number of accounts involved in this cycle, including both income statement and balance sheet accounts. The effect is an increased potential for classification misstatements, some of which are likely to affect income. An example is a misclassification between repair and maintenance expenses and fixed assets. As a result, auditors often reduce the tolerable exception rate, especially for the classification attribute.
2. It is more common in this cycle for transactions to require significant judgment, such as for leases and construction costs. These judgment requirements result in an increased likelihood of misstatements. As a result, auditors often reduce the tolerable exception rate for the accuracy attribute.
3. The dollar amounts of individual transactions in the cycle cover a wide range. As a result, auditors commonly segregate large and unusual items and test them on a 100 percent basis.

METHODOLOGY FOR DESIGNING TESTS OF DETAILS OF BALANCES FOR ACCOUNTS PAYABLE

OBJECTIVE 18-4

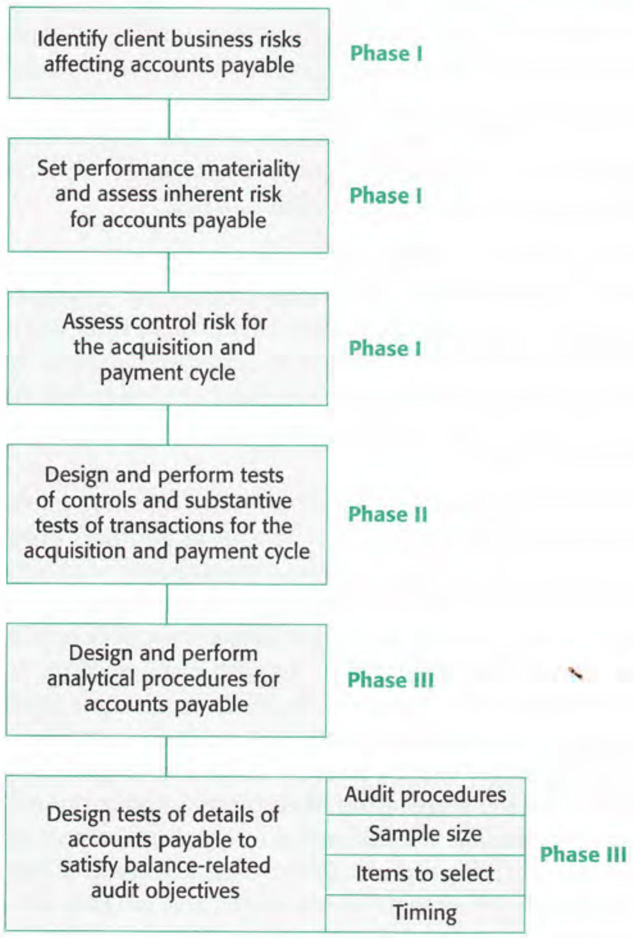
Describe the methodology for designing tests of details of balances for accounts payable using the audit risk model.

Because all acquisition and payment cycle transactions typically flow through accounts payable, this account is critical to any audit of the acquisition and payment cycle. Accounts payable are *unpaid obligations* for goods and services received in the ordinary course of business. Accounts payable includes obligations for the acquisition of raw materials, equipment, utilities, repairs, and many other types of goods and services that were received before the end of the year. Most accounts payable can also be identified by the existence of vendors' invoices for the obligation.

Accounts payable should be distinguished from accrued liabilities and interest-bearing obligations. A liability is an account payable only if the total amount of the obligation is *known and owed at the balance sheet date.* If the obligation includes the payment of interest, it should be recorded as a note payable, contract payable, mortgage payable, or bond payable.

Figure 18-3 summarizes the methodology for designing tests of details for accounts payable. This methodology is the same as that used for accounts receivable in Chapter 16 (see Figure 16-1 on page 539).

FIGURE 18-3 **Methodology for Designing Tests of Details of Balances for Accounts Payable**



If tests of controls and related substantive tests of transactions show that controls are operating effectively, and if analytical procedures results are satisfactory, the auditor is likely to reduce tests of details of balances for accounts payable. However, because accounts payable tend to be material for most companies, auditors almost always perform some tests of details of balances.

Identify Client Business Risks Affecting Accounts Payable (Phase I)

The recent focus by many companies on improving their supply-chain management activities has led to numerous changes in the design of systems used to initiate and record acquisition and payment activities. Efforts to streamline the purchasing of goods and services, including greater emphasis on just-in-time inventory purchasing, increased sharing of information with suppliers, and the use of technology and e-commerce to transact business, are changing all aspects of the acquisition and payment cycle for many companies. These arrangements and systems can be complex.

Significant client business risks may arise from these changes. For example, suppliers may have greater access to accounts payable records, allowing them to continually monitor the status of payable balances and to perform detailed reconciliations of transactions. Access by external parties, such as suppliers, to accounting records threatens the likelihood of misstatement if that access is not properly controlled. Also, increased focus on improving the logistics of physically moving inventory throughout a company's distribution chain may increase the difficulty of establishing effective cutoff of accounts payable balances at year-end. The auditor needs to understand the nature of changes to these systems to identify whether client business risks and related management controls affect the likelihood of material misstatements in accounts payable.

Set Performance Materiality and Assess Inherent Risk (Phase I)

Like accounts receivable, a large number of transactions can affect accounts payable. The balance is often large and made up of a large number of vendor balances and it is relatively expensive to audit the account. For these reasons, auditors typically set performance materiality for accounts payable relatively high. For the same reasons, auditors often assess inherent risk as medium or high. They are especially concerned about the completeness and cutoff balance-related audit objectives because of the potential for understatements in the account balance.

Assess Control Risk and Design and Perform Tests of Controls and Substantive Tests of Transactions (Phases I and II)

As shown in Figure 18-3 (p. 625), after auditors set performance materiality and inherent risk for accounts payable, they assess control risk based on an understanding of internal control. The auditor's ultimate substantive tests depend on the relative effectiveness of internal controls related to accounts payable. Therefore, auditors must have a thorough understanding of how these controls relate to accounts payable.

The effects of the client's internal controls on accounts payable tests can be illustrated by two examples:

1. Assume that the client has highly effective internal controls over recording and paying for acquisitions. The receipt of goods is promptly documented by prenumbered receiving reports; prenumbered vouchers are promptly and efficiently prepared and recorded in the acquisition transactions file and the accounts payable master file. Cash disbursements are made promptly when due and immediately recorded in the cash disbursements transactions file and the accounts payable master file. Individual accounts payable balances in the master file are reconciled monthly with vendors' statements, and the computer automatically reconciles the master file total to the general ledger. Under these circumstances, the verification of accounts payable should require little audit effort once the auditor concludes that internal controls are operating effectively.
2. Assume that receiving reports are not used, the client defers recording acquisitions until cash disbursements are made, and because of cash shortages, bills are often paid several months after their due date. When an auditor faces such a situation, there is a high likelihood of an understatement of accounts payable;

TABLE 18-4 Analytical Procedures for the Acquisition and Payment Cycle

Analytical Procedure	Possible Misstatement
Compare acquisition-related expense account balances with prior years.	Misstatement of accounts payable and expenses.
Review list of accounts payable for unusual, nonvendor, and interest-bearing payables.	Classification misstatement for nontrade liabilities.
Compare individual accounts payable with previous years.	Unrecorded or nonexistent accounts, or misstatements.
Calculate ratios, such as purchases divided by accounts payable, and accounts payable divided by current liabilities.	Unrecorded or nonexistent accounts, or misstatements.

therefore, extensive tests of details of accounts payable are necessary to determine whether accounts payable is correctly stated on the balance sheet date.

We discussed the most important controls over accounts payable and the related tests of controls and substantive tests of transactions earlier in this chapter. In addition to those controls, each month an independent person or computer program should reconcile vendors' statements with recorded liabilities and the accounts payable master file with the general ledger. After assessing control risk, the auditor designs and performs tests of controls and substantive tests of transactions for acquisitions and cash disbursements.

Design and Perform Analytical Procedures (Phase III)

OBJECTIVE 18-5

Design and perform analytical procedures for accounts payable.

The use of analytical procedures is as important in the acquisition and payment cycle as it is in every other cycle, especially for uncovering misstatements in accounts payable. Table 18-4 illustrates analytical procedures for the balance sheet and income statement accounts in the acquisition and payment cycle that are useful for uncovering areas in which additional investigation is desirable.

Auditors should compare current year expense totals with prior years to uncover misstatements of accounts payable as well as in the expense accounts. Because of double-entry accounting, a misstatement of an expense account usually also results in an equal misstatement of accounts payable. Therefore, comparing current expenses such as rent, utilities, and other regularly scheduled bills with prior years is an effective procedure for analyzing accounts payable when expenses from year to year are expected to be relatively stable.

Design and Perform Tests of Details of Accounts Payable Balance (Phase III)

OBJECTIVE 18-6

Design and perform tests of details of balances for accounts payable, including out-of-period liability tests.

The overall objective in the audit of accounts payable is to determine whether the accounts payable balance is fairly stated and properly disclosed. Seven of the eight balance-related audit objectives discussed in Chapter 6 (pp. 179–181) are applicable to accounts payable: existence, completeness, accuracy, classification, cutoff, detail tie-in, and rights and obligations. Realizable value is not applicable to liabilities.

There is an important difference in emphasis in the audit of liabilities and assets. When auditors verify assets, they emphasize overstatements through verification by confirmation, physical examination, and examination of supporting documents. The opposite approach is taken in verifying liability balances; that is, the main focus is on understated or omitted liabilities.

The difference in emphasis in auditing assets and liabilities results directly from the *legal liability of CPAs*. If equity investors, creditors, and other users determine subsequent to the issuance of the audited financial statements that earnings and owners' equity were materially overstated, a lawsuit against the CPA firm is fairly likely. Because an overstatement of owners' equity can arise either from an overstatement of assets or an understatement of liabilities, it is natural for CPAs to emphasize those two types of misstatements. Auditors should not ignore the possibility that assets are understated or liabilities are overstated, and should design tests to detect material understatements of earnings and owners' equity, including those arising from material overstatements of accounts payable.

We will use the same balance-related audit objectives from Chapter 16 that we applied to verifying accounts receivable, as they also apply to liabilities, with three minor modifications:

1. The realizable value objective is not applicable to liabilities. Realizable value applies only to assets.
2. The rights aspect of the rights and obligations objective is not applicable to liabilities. For assets, the auditor is concerned with the client's rights to the use and disposal of the assets. For liabilities, the auditor is concerned with the client's obligations for the payment of the liability. If the client has no obligation to pay a liability, it should not be included as a liability.
3. For liabilities, there is emphasis on the search for understatements rather than for overstatements, as we just discussed.

Table 18-5 includes the balance-related audit objectives and common tests of details of balances procedures for accounts payable. The auditor's actual audit procedures vary considerably depending on the nature of the entity, the materiality

TABLE 18-5 Balance-Related Audit Objectives and Tests of Details of Balances for Accounts Payable

Balance-Related Audit Objective	Common Tests of Details of Balances Procedures	Comments
Accounts payable in the accounts payable list agree with related master file, and the total is correctly added and agrees with the general ledger (detail tie-in).	Re-add or use the computer to total the accounts payable list. Trace the total to the general ledger. Trace individual vendors' invoices to master file for names and amounts.	All pages need not ordinarily be footed if footing manually. Unless controls are deficient, tracing to master file should be limited.
Accounts payable in the accounts payable list exist (existence).	Trace from accounts payable list to vendors' invoices and statements. Confirm accounts payable, emphasizing large and unusual amounts.	Ordinarily receives little attention because the primary concern is with understatements.
Existing accounts payable are included in the accounts payable list (completeness).	Perform out-of-period liability tests (see discussion).	These are essential audit tests for accounts payable.
Accounts payable in the accounts payable list are accurate (accuracy).	Perform same procedures as those used for existence objective and out-of-period liability tests.	Ordinarily, the emphasis in these procedures for accuracy is understatement rather than omission.
Accounts payable in the accounts payable list are correctly classified (classification).	Review the list and master file for related parties, notes or other interest-bearing liabilities, long-term payables, and debit balances.	Knowledge of the client's business is essential for these tests.
Transactions in the acquisition and payment cycle are recorded in the proper period (cutoff).	Perform out-of-period liability tests (see discussion). Perform detailed tests as part of physical observation of inventory (see discussion). Test for inventory in transit (see discussion).	These are essential audit tests for accounts payable. These are called *cutoff tests.*
The company has an obligation to pay the liabilities included in accounts payable (obligations).	Examine vendors' statements and confirm accounts payable.	Normally not a concern in the audit of accounts payable because all accounts payable are obligations.

of accounts payable, the nature and effectiveness of internal controls, and inherent risk. As auditors perform test of details of balances for accounts payable and other liability accounts they may also gather evidence about the four presentation and disclosure objectives, especially when performing completeness objective tests. Other procedures related to presentation and disclosure objectives are done as part of procedures to complete the audit, which we will discuss in Chapter 24.

Out-of-Period Liability Tests Because of the emphasis on understatements in liability accounts, *out-of-period liability tests* are important for accounts payable. The extent of tests to uncover unrecorded accounts payable, often called the *search for unrecorded accounts payable*, depends heavily on assessed control risk and the materiality of the potential balance in the account. The same audit procedures used to uncover unrecorded payables are applicable to the accuracy objective. The following are typical audit procedures:

Examine Underlying Documentation for Subsequent Cash Disbursements Auditors examine supporting documentation for cash disbursements subsequent to the balance sheet date to determine whether a cash disbursement was for a current period liability. If it is a current period liability, the auditor should trace it to the accounts payable trial balance to make sure it is included. The receiving report indicates the date inventory was received and is therefore an especially useful document. Similarly, the vendor's invoice usually indicates the date services were provided. Auditors often examine documentation for cash disbursements made in the subsequent period for several weeks after the balance sheet date, especially when the client does not pay bills on a timely basis.

Examine Underlying Documentation for Bills Not Paid Several Weeks After the Year-End Auditors carry out this procedure in the same manner as the preceding one and for the same purpose. This procedure differs in that it is done for unpaid obligations near the end of the audit rather than for obligations that have already been paid.

For example, in an audit with a March 31 year-end, assume the auditor examines the supporting documentation for checks paid through June 28. Bills that are still unpaid on June 28 should be examined to determine whether they are obligations at March 31.

Trace Receiving Reports Issued Before Year-End to Related Vendors' Invoices All merchandise received before the year-end of the accounting period should be included as accounts payable. By tracing receiving reports issued up to year-end to vendors' invoices and making sure that they are included in accounts payable, the auditor is testing for unrecorded obligations.

Trace Vendors' Statements That Show a Balance Due to the Accounts Payable Trial Balance If the client maintains a file of vendors' statements, auditors can trace any statement that has a balance due at the balance sheet date to the listing to make sure it is included as an account payable.

Send Confirmations to Vendors with Which the Client Does Business Although the use of confirmations for accounts payable is less common than for accounts receivable, auditors use them occasionally to test for vendors omitted from the accounts payable list, omitted transactions, and misstated account balances. Sending confirmations to active vendors for which a balance has not been included in the accounts payable list is a useful means of searching for omitted amounts. This type of confirmation is commonly called a zero balance confirmation. Additional discussion of confirmation of accounts payable is deferred until the end of this chapter.

Cutoff Tests Accounts payable **cutoff tests** are done to determine whether transactions recorded a few days before and after the balance sheet date are included in the correct period. The five out-of-period liability audit tests we just discussed are all cutoff tests for acquisitions, but they emphasize understatements. For the first three procedures, it is also appropriate to examine supporting documentation as a test of overstatement of accounts payable. For example, the third procedure tests for understatements (unrecorded accounts payable) by tracing receiving reports issued before year-end to related vendors' invoices. To test for overstatement cutoff amounts, the auditor should trace receiving reports issued *after* year-end to related invoices to make sure that they are not recorded as accounts payable (unless they are inventory in transit, which is discussed shortly).

We've already discussed most cutoff tests in the preceding section, but we will focus on two aspects here: the relationship of cutoff to physical observation of inventory and the determination of the amount of inventory in transit.

Relationship of Cutoff to Physical Observation of Inventory In determining that the accounts payable cutoff is correct, *it is essential that the cutoff tests be coordinated with the physical observation of inventory.* For example, assume that an inventory acquisition for $400,000 is received late in the afternoon of December 31, after the physical inventory is completed. If the acquisition is included in accounts payable and purchases but excluded from ending inventory, the result is an understatement of net earnings of $400,000. Conversely, if the acquisition is excluded from both inventory and accounts payable, there is a misstatement in the balance sheet, but the income statement is correct. The only way the auditor will know which type of misstatement has occurred is to coordinate cutoff tests with the observation of inventory.

The cutoff information for acquisitions should be obtained *during the physical observation* of inventory. At that time, the auditor should review the procedures in the receiving department to determine that all inventory received was counted, and the auditor should record in the audit documentation the last receiving report number of inventory included in the physical count. Subsequent to the physical count date, the auditor should then test the accounting records for cutoff. The auditor should trace the previously documented receiving report numbers to the accounts payable records to verify that they are correctly included or excluded. For example, assume that the last receiving report number representing inventory included in the physical count was 3167. The auditor should record this document number and subsequently trace it and several preceding numbers to their related vendors' invoices and to the accounts payable list or the accounts payable master file to determine that they are all included. Similarly, accounts payable for acquisitions recorded on receiving reports with numbers larger than 3167 should be excluded from accounts payable.

When the client's physical inventory takes place before the last day of the year, the auditor must still perform an accounts payable cutoff at the time of the physical count in the manner described in the preceding paragraph. In addition, the auditor must verify whether all acquisitions that took place between the physical count and the end of the year were added to the physical inventory and accounts payable.

Inventory in Transit In accounts payable, auditors must distinguish between acquisitions of inventory that are on an **FOB destination** basis and those that are made **FOB origin**. For FOB destination, title passes to the buyer when the inventory is received, so only inventory received on or before the balance sheet date should be included in inventory and accounts payable at year-end. When an acquisition is FOB origin, the company must record the inventory and related accounts payable in the current period if shipment occurred on or before the balance sheet date.

Auditors can determine whether inventory has been acquired FOB destination or origin by examining vendors' invoices. Auditors should examine invoices for merchandise received shortly after year-end to determine whether they were on an FOB origin basis. For those that were, and when the shipment dates were on or before the balance sheet date, the inventory and related accounts payable must be recorded in the current period if the amounts are material.

Reliability of Evidence

OBJECTIVE 18-7

Distinguish the reliability of vendors' invoices, vendors' statements, and confirmations of accounts payable as audit evidence.

Auditors need to understand the relative reliability of the three primary types of evidence ordinarily used for verifying accounts payable: vendors' invoices, vendors' statements, and confirmations.

Distinction Between Vendors' Invoices and Vendors' Statements Auditors should distinguish between vendors' invoices and vendors' statements in verifying the amount due to a vendor. Auditors get highly reliable *evidence about individual transactions* when they examine vendors' invoices and related supporting documents, such as receiving reports and purchase orders. A vendor's statement is not as desirable as invoices for verifying individual transactions because a statement includes only the total amount of the transaction. The units acquired, price, freight, and other data are not included.

Which of these two documents is better for verifying the correct balance in accounts payable? *The vendor's statement is superior for verifying accounts payable* because it includes the ending balance. The auditor can compare existing vendors' invoices with the client's list and still not uncover missing ones, which is the primary concern in accounts payable.

Which of these two documents is better for testing acquisitions in tests of controls and substantive tests of transactions? *The vendor's invoice is superior for verifying transactions* because the auditor is verifying individual transactions and the invoice shows the details of the acquisitions.

Difference Between Vendors' Statements and Confirmations The most important distinction between a vendor's statement and a confirmation of accounts payable is the source of the information. A vendor's statement has been prepared by the vendor (an independent third party) but is in the hands of the client at the time the auditor examines it. This provides the client with an opportunity to alter a vendor's statement or to withhold certain statements from the auditor.

FIGURE 18-4 **Accounts Payable Confirmation Request**

January 15, 2014

ROGER MEAD, INC.
Jones Sales, Inc.
2116 Stewart Street
Wayneville, Kentucky 36021

To Whom It May Concern:

Our auditors, Murray and Rogers, CPAs, are conducting an audit of our financial statements. For this purpose, please furnish them with the following information as of December 31, 2013.

(1) Itemized statements of our accounts payable to you showing all unpaid items;
(2) A complete list of any notes and acceptances payable to you (including any which have been discounted) showing the original date, dates due, original amount, unpaid balance, collateral, and endorsers; and
(3) An itemized list of your merchandise consigned to us.

Your prompt attention to this request will be appreciated. An envelope is enclosed for your reply.

Yours truly,

Phil Geriovini

Phil Geriovini, President

A response to a confirmation request for accounts payable is normally an itemized statement sent directly to the CPA's office by the vendor. It provides the same information as a vendor's statement but is more reliable. In addition, confirmations of accounts payable often include a request for information about notes and acceptances payable as well as consigned inventory owned by the vendor but stored on the client's premises. An illustration of a typical accounts payable confirmation request is given in Figure 18-4 (p. 631).

Due to the availability of vendors' statements and vendors' invoices, which are both relatively reliable evidence because they originate from a third party, confirmation of accounts payable is less common than confirmation of accounts receivable. If the client has adequate internal controls and vendors' statements are available for examination, confirmations are normally not sent. However, when the client's internal controls are deficient, when statements are not available, or when the auditor questions the client's integrity, it is desirable to send confirmation requests to vendors. Because of the emphasis on understatements of liability accounts, the accounts confirmed should include large, active, zero balance accounts and a representative sample of all others.

When auditors examine vendors' statements or receive confirmations, there must be a reconciliation of the statement or confirmation with the accounts payable list. Differences are often caused by inventory in transit, checks mailed by the client but not received by the vendor at the statement date, and delays in processing accounting records. The reconciliation is of the same general nature as that discussed in Chapter 16 for accounts receivable. The documents typically used to reconcile the balances on the accounts payable list with the confirmations or vendors' statements include receiving reports, vendors' invoices, and cancelled checks.

Sample Size

Our discussion of tests of details of the accounts payable balance has focused heavily on the typical audit procedures performed, the documents and records examined, and the timing of the tests. The auditor must also consider sample sizes in the audit of accounts payable.

Sample sizes for accounts payable tests vary considerably, depending on such factors as the materiality of accounts payable, the number of accounts outstanding, assessed control risk, and the results of the prior year. When a client's internal controls are deficient, which is not uncommon for accounts payable, almost all population items must be verified. In other situations, minimal testing may suffice.

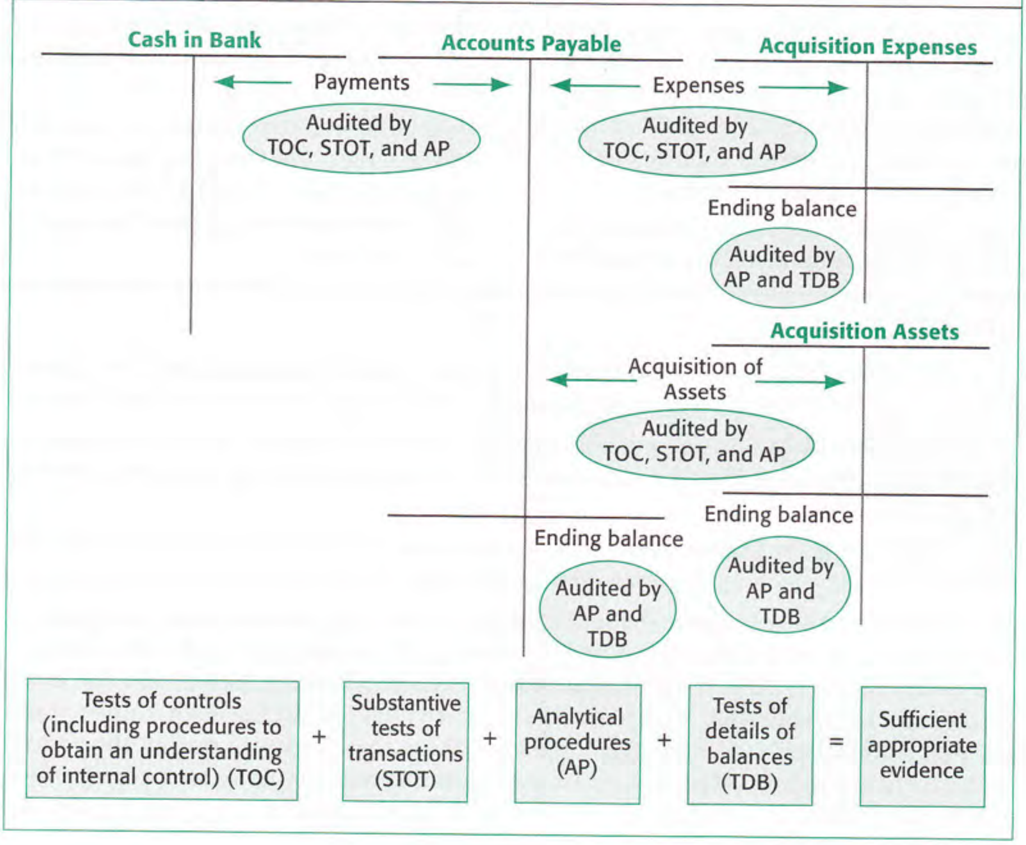
Statistical sampling is less commonly used for the audit of accounts payable than for accounts receivable. Defining the population and determining the population size is more difficult for accounts payable. Because the emphasis is on omitted accounts payable, auditors must try to ensure that the population includes all potential payables.

SUMMARY

Figure 18-5 summarizes how the four types of audit procedures are used to obtain audit assurance for transactions and accounts in the acquisition and payment cycle. After using procedures to obtain an understanding of internal control and tests of controls, auditors can evaluate whether controls over transactions in the cycle are operating effectively. When control risk is assessed as low the auditor can reduce substantive testing of ending balances in the related accounts. On the other hand, a higher assessed control risk results in the need for more substantive testing in related accounts. In this chapter, the ending balance we focused on was accounts payable.

By combining all types of audit tests shown in Figure 18-5, the auditor can obtain a higher overall assurance for transactions and accounts in the acquisition and payment cycle than the assurance obtained from any one test. The auditor can increase the assurance obtained from any one of the tests, and thereby increase the overall assurance for the cycle.

FIGURE 18-5 Types of Audit Tests for the Acquisition and Payment Cycle (see Figure 18-1 on page 614 for accounts)



ESSENTIAL TERMS

Accounts payable master file—a computer file for maintaining a record for each vendor of individual acquisitions, cash disbursements, acquisition returns and allowances, and vendor balances

Accounts payable trial balance—a listing of the amount owed to each vendor at a point in time; prepared directly from the accounts payable master file

Acquisition and payment cycle—the transaction cycle that includes the acquisition of and payment for goods and services from suppliers outside the organization

Acquisitions journal—a journal or listing generated from the acquisitions transaction file and typically includes information such as vendor name, date, amount, and account classification for each transaction

Cutoff tests—tests to determine whether transactions recorded a few days before and after the balance sheet date are included in the correct period

Debit memo—a document indicating a reduction in the amount owed to a vendor because of returned goods or an allowance granted

FOB destination—shipping contract in which title to the goods passes to the buyer when the goods are received

FOB origin—shipping contract in which title to the goods passes to the buyer at the time that the goods are shipped

Purchase order—a document prepared or electronically issued by the purchasing department indicating the description, quantity, and related information for goods and services that the company intends to purchase

Purchase requisition—request by an authorized employee to the purchasing department to place an order for inventory and other items used by an entity

Receiving report—a document prepared by the receiving department at the time tangible goods are received, indicating the description of the goods, the quantity received, the date received, and other relevant data; it is part of the documentation necessary for payment to be made

Vendor's invoice—a document or record that specifies the details of an acquisition transaction and amount of money owed to the vendor for an acquisition

Vendor's statement—a statement prepared monthly by the vendor, which indicates the customer's beginning balance, acquisitions, payments, and ending balance

Voucher—a document used to establish a formal means of recording and controlling acquisitions, primarily by enabling each acquisition transaction to be sequentially numbered

REVIEW QUESTIONS

18-1 (Objective 18-1) List five asset accounts, three liability accounts, and five expense accounts included in the acquisition and payment cycle for a typical manufacturing company.

18-2 (Objective 18-3) List one possible internal control for each of the six transaction-related audit objectives for cash disbursements. For each control, list a test of control to test its effectiveness.

18-3 (Objective 18-3) List one possible control for each of the six transaction-related audit objectives for acquisitions. For each control, list a test of control to test its effectiveness.

18-4 (Objective 18-3) Evaluate the following statement by an auditor concerning tests of acquisitions and cash disbursements: "In selecting the acquisitions and cash disbursements sample for testing, the best approach is to select a random month and test every transaction for the period. Using this approach enables me to thoroughly understand internal control because I have examined everything that happened during the period. As a part of the monthly test, I also test the beginning and ending bank reconciliations and prepare a proof of cash for the month. At the completion of these tests I feel I can evaluate the effectiveness of internal control."

18-5 (Objective 18-3) What is the importance of cash discounts to the client and how can the auditor verify whether they are being taken in accordance with company policy?

18-6 (Objective 18-3) What are the similarities and differences in the objectives of the following two procedures? (1) Select a random sample of receiving reports and trace them to related vendors' invoices and acquisitions journal entries, comparing the vendor's name, type of material and quantity acquired, and total amount of the acquisition. (2) Select a random sample of acquisitions journal entries and trace them to related vendors' invoices and receiving reports, comparing the vendor's name, type of material and quantity acquired, and total amount of the acquisition.

18-7 (Objectives 18-2, 18-3) If an audit client does not have prenumbered checks, what type of misstatement has a greater chance of occurring? Under the circumstances, what audit procedure can the auditor use to compensate for the deficiency?

18-8 (Objective 18-2) What is meant by a voucher? Explain how its use can improve an organization's internal controls.

18-9 (Objective 18-2) Explain why most auditors consider the receipt of goods and services the most important point in the acquisition and payment cycle.

18-10 (Objectives 18-3, 18-6) Explain the relationship between tests of the acquisition and payment cycle and tests of inventory. Give specific examples of how these two types of tests affect each other.

18-11 (Objectives 18-3, 18-4) Explain the relationship between tests of the acquisition and payment cycle and tests of accounts payable. Give specific examples of how these two types of tests affect each other.

18-12 (Objective 18-6) The CPA examines all unrecorded invoices on hand as of February 28, 2014, the last day of the audit. Which of the following misstatements is most likely to be uncovered by this procedure? Explain.

a. Accounts payable are overstated at December 31, 2013.
b. Accounts payable are understated at December 31, 2013.
c. Operating expenses are overstated for the 12 months ended December 31, 2013.
d. Operating expenses are overstated for the two months ended February 28, 2014.*

18-13 (Objective 18-7) Explain why it is common for auditors to send confirmation requests to vendors with "zero balances" on the client's accounts payable listing but uncommon to follow the same approach in verifying accounts receivable.

18-14 (Objectives 18-2, 18-7) Distinguish between a vendor's invoice and a vendor's statement. Which document should ideally be used as evidence in auditing acquisition transactions and which for verifying accounts payable balances? Why?

18-15 (Objective 18-7) It is less common to confirm accounts payable at an interim date than accounts receivable. Explain why.

18-16 (Objective 18-6) In testing the cutoff of accounts payable at the balance sheet date, explain why it is important that auditors coordinate their tests with the physical observation of inventory. What can the auditor do during the physical inventory to enhance the likelihood of an accurate cutoff?

18-17 (Objective 18-6) Distinguish between FOB destination and FOB origin. What procedures should the auditor follow concerning acquisitions of inventory on an FOB origin basis near year-end?

MULTIPLE CHOICE QUESTIONS FROM CPA EXAMINATIONS

18-18 (Objective 18-3) The following questions concern internal controls in the acquisition and payment cycle. Choose the best response.

a. Budd, the purchasing agent of Lake Hardware Wholesalers, has a relative who owns a retail hardware store. Budd arranged for hardware to be delivered by manufacturers to the relative's retail store on a COD basis, thereby enabling his relative to buy at Lake's wholesale prices. Budd was probably able to accomplish this because of Lake's poor internal control over
   (1) purchase requisitions.
   (2) purchase orders.
   (3) cash receipts.
   (4) perpetual inventory records.

b. Which of the following is an internal control that will prevent paid cash disbursement documents from being presented for payment a second time?
   (1) The date on cash disbursement documents must be within a few days of the date that the document is presented for payment.
   (2) The official signing the check compares the check with the documents and should deface the documents.
   (3) Unsigned checks are prepared by individuals who are responsible for signing checks.
   (4) Cash disbursement documents are approved by at least two responsible management officials.

c. Which of the following questions would be best to include in an internal control questionnaire concerning the completeness assertion for purchases?
   (1) Is an authorized purchase order required before the receiving department can accept a shipment or the vouchers payable department can record a voucher?
   (2) Are purchase requisitions prenumbered and independently matched with vendor invoices?
   (3) Is the unpaid voucher file periodically reconciled with inventory records by an employee who does not have access to purchase requisitions?
   (4) Are purchase orders, receiving reports, and vouchers prenumbered and periodically accounted for?

d. The authority to accept incoming goods in receiving should be based on a(n)
   (1) vendor's invoice.
   (2) purchase requisition.
   (3) bill of lading.
   (4) approved purchase order.

18-19 (Objectives 18-6, 18-7) The following questions concern accumulating evidence in the acquisition and payment cycle. Choose the best response.

a. In auditing accounts payable, an auditor's procedures most likely will focus primarily on management's assertion of
   (1) existence.
   (2) realizable value.
   (3) completeness.
   (4) valuation and allocation.

b. Which of the following audit procedures is best for identifying unrecorded trade accounts payable?
   (1) Examining unusual relationships between monthly accounts payable balances and recorded cash payments.
   (2) Reconciling vendors' statements to the file of receiving reports to identify items received just prior to the balance sheet date.
   (3) Reviewing cash disbursements recorded subsequent to the balance sheet date to determine whether the related payables apply to the prior period.
   (4) Investigating payables recorded just prior to and just subsequent to the balance sheet date to determine whether they are supported by receiving reports.

c. An auditor traced a sample of purchase orders and the related receiving reports to the acquisitions journal and cash disbursements journal. The purpose of this substantive test of transactions most likely was to
   (1) identify unusually large purchases that should be investigated further.
   (2) verify that cash disbursements were for goods actually received.
   (3) determine that purchases were properly recorded.
   (4) test whether payments were for goods actually ordered.

18-20 (Objectives 18-3, 18-6) The following questions concern the audit of accounts payable.

a. For effective internal control, the accounts payable department generally should
   (1) stamp, perforate, or otherwise cancel supporting documentation after payment is mailed.
   (2) ascertain that each requisition is approved as to price, quantity, and quality by an authorized employee.
   (3) omit information about the quantity ordered on the copy of the purchase order forwarded to the receiving department prior to receipt of goods.
   (4) establish the agreement of the vendor's invoice with the receiving report and purchase order.

b. When using confirmations to provide evidence about the completeness assertion for accounts payable, the appropriate population most likely is
   (1) vendors with whom the entity has previously done business.
   (2) amounts recorded in the accounts payable subsidiary ledger.
   (3) payees of checks drawn in the month after year-end.
   (4) invoices filed in the entity's open invoice file.

DISCUSSION QUESTIONS AND PROBLEMS

18-21 (Objective 18-3) Questions 1 through 8 are typically found in questionnaires used by auditors to obtain an understanding of internal control in the acquisition and payment cycle. In using the questionnaire for a client, a "yes" response to a question indicates a possible internal control, whereas a "no" indicates a potential deficiency.

1. Is the purchasing function performed by personnel who are independent of the receiving and shipping functions and the payables and disbursing functions?
2. Are all receiving reports prenumbered and the numerical sequence checked by a person independent of check preparation?
3. Are all vendors' invoices routed directly to accounting from the mailroom?
4. Does a responsible employee review and approve the invoice account distribution before the transaction is entered in the computer?
5. Are all extensions, footings, discounts, and freight terms on vendors' invoices checked for accuracy?

6. Are checks automatically posted in the cash disbursements journal as they are prepared?
7. Are all supporting documents properly cancelled at the time the checks are signed?
8. Is the custody of checks after signature and before mailing handled by an employee independent of all payable, disbursing, cash, and general ledger functions?

Required

a. For each of the preceding questions, state the transaction-related audit objective(s) being fulfilled if the control is in effect.

b. For each internal control, list a test of control to test its effectiveness.

c. For each of the preceding questions, identify the nature of the potential financial misstatement(s) if the control is not in effect.

d. For each of the potential misstatements in part c., list a substantive audit procedure that can be used to determine whether a material misstatement exists.

18-22 (Objective 18-3) The following audit procedures are included in the audit program for the audit of the financial statements of Golden State Overnight Express:

1. Select a sample of acquisitions from the acquisitions journal and perform the following:
   a. Vouch the transaction to the voucher package that includes the matched receiving report, purchase order, and vendor invoice.
   b. Verify that the purchase order was approved by an authorized purchasing agent.
   c. Verify that the initials of accounts payable clerk are present, indicating that the documents have been appropriately matched and that amounts on the vendor invoice were verified.
   d. Recalculate the invoice amount and compare the dollar amounts per the invoice to the amount recorded in the acquisitions journal.
   e. Examine whether the transaction was recorded to the correct vendor in the accounts payable master file.
   f. Determine if the transaction was recorded in the correct month, based on when the goods were received and the terms of the transaction.
   g. Review the chart of accounts to determine if the transaction was charged to the appropriate general ledger account.
2. Discuss with the accounts payable personnel the nature of procedures they perform when matching acquisitions documentation and discuss the types of discrepancies they typically find and how those are resolved.
3. Scan the acquisitions journal for any unusual entries and investigate those noted.
4. Foot the acquisitions journal for two months of the year and determine that amounts were correctly recorded in the general ledger accounts.
5. Trace a sample of voucher packages to the acquisitions journal throughout the year to determine that the transaction is included in the acquisitions journal.

Required

For each of the above procedures (consider 1.a. through 1.g. as separate procedures), perform the following:

a. Identify the type of audit evidence used for each procedure.

b. Identify the transaction-related audit objective(s) satisfied by each procedure.

c. Identify whether the procedure is a test of control or substantive test of transaction.

18-23 (Objective 18-3) Donnen Designs, Inc., is a small manufacturer of women's casual-wear jewelry, including bracelets, necklaces, earrings, and other moderately priced accessory items. Most of their products are made from silver, various low-cost stones, beads, and other decorative jewelry pieces. Donnen Designs is not involved in the manufacturing of high-end jewelry items, such as those made of gold and semiprecious or precious stones.

Personnel responsible for purchasing raw material jewelry items for Donnen Designs would like to place orders directly with suppliers who offer their products for sale through Internet Web sites. Most suppliers provide pictures of all jewelry components on their Web sites, along with pricing and other sales-term information. Customers who have valid business licenses are able to purchase the products at wholesale, rather than retail prices. Customers can place orders online and pay for those goods immediately by using a valid credit card. Purchases made by credit card are shipped by the suppliers after the credit approval is received from the credit card agency, which usually occurs the same day. Customers can also place orders online with payment being later made by check. However, in that event, purchases are not shipped until the check is received and cashed by the supplier. Some of the suppliers allow a 30-day full-payment refund policy, whereas other suppliers accept returns but only grant credit toward future purchases from that supplier.

Required

a. Identify advantages for Donnen Designs if management allows purchasing personnel to order goods online through supplier Web sites.

b. Identify potential risks associated with Donnen Designs' purchase of jewelry pieces through supplier Internet Web sites.

c. Describe advantages of allowing purchasing agents to purchase products online using a Donnen Designs credit card.

d. Describe advantages of allowing purchasing agents to purchase products online with payment made only by check.

e. What internal controls can be implemented to ensure that

(1) purchasing agents do not use Donnen credit cards to purchase nonjewelry items for their own purposes, if Donnen allows purchasing agents to purchase jewelry using Donnen credit cards?

(2) purchasing agents do not order jewelry items from the suppliers and ship those items to addresses other than Donnen addresses?

(3) Donnen does not end up with unused credits with jewelry suppliers as a result of returning unacceptable jewelry items to suppliers who only grant credit toward future purchases?

18-24 (Objectives 18-3, 18-6) The following misstatements are included in the accounting records of Westgate Manufacturing Company.

1. Each month, a fraudulent receiving report is submitted to accounting by an employee in the receiving department. A few days later, he sends Westgate an invoice for the quantity of goods ordered from a small company he owns and operates in the evening. A check is prepared, and the amount is paid when the receiving report and the vendor's invoice are matched by the accounts payable clerk.
2. Telephone expense (account 2112) was unintentionally charged to repairs and maintenance (account 2121).
3. The accounts payable clerk prepares a monthly check to Story Supply Company for the amount of an invoice owed and submits the unsigned check to the treasurer for payment along with related supporting documents that have already been approved. When she receives the signed check from the treasurer, she records it as a debit to accounts payable and deposits the check in a personal bank account for a company named Story Company. A few days later, she records the invoice in the acquisitions journal again, resubmits the documents and a new check to the treasurer, and sends the check to the vendor after it has been signed.
4. The amount of a check in the cash disbursements journal is recorded as $4,612.87 instead of $6,412.87.
5. The accounts payable clerk intentionally excluded from the cash disbursements journal seven large checks written and mailed on December 26 to prevent cash in the bank from having a negative balance on the general ledger. They were recorded on January 2 of the subsequent year.
6. Acquisitions of raw materials are often not recorded until several weeks after the goods are received because receiving personnel fail to forward receiving reports to accounting. When pressure from a vendor's credit department is put on Westgate's accounting department, it searches for the receiving report, records the transactions in the acquisitions journal, and pays the bill.

Required

a. For each misstatement, identify the transaction-related audit objective that was not met.

b. For each misstatement, state a control that should have prevented it from occurring on a continuing basis.

c. For each misstatement, state a substantive audit procedure that could uncover it.

18-25 (Objectives 18-5, 18-6, 18-7) The following auditing procedures were performed in the audit of accounts payable:

1. Obtain a list of accounts payable. Re-add and compare with the general ledger.
2. Trace from the general ledger trial balance and supporting documentation to determine whether accounts payable, related parties, and other related assets and liabilities are properly included on the financial statements.
3. For liabilities that are payable in a foreign currency, determine the exchange rate and check calculations.
4. Discuss with the bookkeeper whether any amounts included on the accounts payable list are due to related parties, debit balances, or notes payable.
5. Obtain vendors' statements from the controller and reconcile them to the listing of accounts payable.
6. Obtain vendors' statements directly from vendors and reconcile them to the listing of accounts payable.
7. Examine supporting documents for cash disbursements several days before and after year-end.
8. Examine the acquisitions and cash disbursements journals for the last few days of the current period and first few days of the succeeding period, looking for large or unusual transactions.

Required

a. For each procedure, identify the type of audit evidence used.
b. For each procedure, identify which balance-related audit objective(s) were satisfied.
c. Evaluate the need to have certain objectives satisfied by more than one audit procedure.

18-26 (Objectives 18-3, 18-4) In testing cash disbursements for the Jay Klein Company, you obtained an understanding of internal control. The controls are reasonably good, and no unusual audit problems arose in previous years.

Although there are not many individuals in the accounting department, there is a reasonable separation of duties in the organization. There is a separate purchasing agent who is responsible for ordering goods and a separate receiving department that counts the goods when they are received and prepares receiving reports. There is a separation of duties between recording acquisitions and cash disbursements, and all information is recorded in the two journals independently. The controller reviews all supporting documents before signing the checks, and he immediately mails the checks to the vendors. Check copies are used for subsequent recording.

All aspects of internal control seem satisfactory to you, and you perform minimum tests of 25 transactions as a means of assessing control risk. In your tests, you discover the following exceptions:

1. One invoice was paid twice. The second payment was supported by a duplicate copy of the invoice. Both copies of the invoice were marked "paid."
2. Two items in the acquisitions journal were misclassified.
3. Three invoices were not initialed by the controller, but there were no dollar misstatements evident in the transactions.
4. Five receiving reports were recorded in the acquisitions journal at least 2 weeks later than their date on the receiving report.
5. Two receiving reports for vendors' invoices were missing from the transaction packets. One vendor's invoice had an extension error, and the invoice was initialed that the amount had been checked.
6. One check amount in the cash disbursements journal was for $100 less than the amount stated on the vendor's invoice.
7. One voided check was missing.

Required

a. Identify whether each of 1 through 7 is a control test deviation, a monetary misstatement, or both.
b. For each exception, identify which transaction-related audit objective was not met.
c. What is the audit importance of each of these exceptions?
d. What follow-up procedures would you use to determine more about the nature of each exception?

e. How would each of these exceptions affect the rest of your audit? Be specific.

f. Identify internal controls that should have prevented each misstatement.

18-27 (Objectives 18-3, 18-6) The Broughton Cap Company requires that prenumbered receiving reports be completed when purchased inventory items arrive in the receiving department. At the time of receipt, the receiving clerk writes the date of receipt on the receiving document. The last receipt in the fiscal year ended June 30, 2013, was recorded on receiving report 7279. The accounts payable department prepares prenumbered voucher packages as receiving reports are received from the receiving department. Entries in the acquisitions journal are prepared using information contained in the voucher package.

For late June 2013 and early July 2013, receipts of goods are included in voucher packages as follows:

Receiving Report No.	Voucher No.
7276	2532
7277	2526
7278	2527
7279	2530
7280	2531
7281	2528
7282	2529

The June 2013 and July 2013 acquisitions journals included the following information:

ACQUISITIONS JOURNAL – JUNE 2013

Day of Month	Voucher No.	Amount of Purchase
29	2526	$7,256.22
29	2528	$3,466.10
30	2531	$8,221.89
30	2532	$1,980.44

ACQUISITIONS JOURNAL – JULY 2013

Day of Month	Voucher No.	Amount of Purchase
1	2527	$5,001.99
1	2529	$4,888.33
2	2530	$1,933.74

Required

a. Which voucher packages, if any, are recorded in the wrong accounting period? Prepare an adjusting entry to correct the financial statements for the year ended June 30, 2013. Assume Broughton uses a perpetual inventory system and all purchases are inventory items.

b. Assume the receiving clerk accidentally wrote June 30 on receiving reports 7280 through 7282. Explain how that will affect the correctness of the financial statements. How will you, as an auditor, discover that error?

c. Describe, in general terms, the audit procedures you would follow in making sure that cutoff for purchases is accurate at the balance sheet date.

d. Identify internal controls that will reduce the likelihood of cutoff misstatements related to purchases.

18-28 (Objective 18-6) You were in the final stages of your audit of the financial statements of Ozine Corporation for the year ended December 31, 2013, when you were consulted by the corporation's president, who believes there is no point to your examining the year 2014 acquisitions journal and testing data in support of year 2014 entries. He stated that (a) bills pertaining to 2013 that were received too late to be included in the December acquisitions journal 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 will 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 2013 bills that were received late? Explain.

b. Should a CPA's test for unrecorded liabilities be eliminated or reduced because of the internal audit tests? Explain.

c. 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 or her knowledge all liabilities have been recorded? Explain.

d. Assume that the corporation, which handled some government contracts, had no internal auditor but that an auditor for a federal agency spent 3 weeks auditing the records and was just completing his work at this time. How will 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 year 2014 acquisitions journal should the CPA consider to locate possible unrecorded liabilities?*

18-29 (Objective 18-3) Cho Books is a company that produces and distributes teaching workbooks and other educational materials to teachers of all levels of schooling, from primary to university. Most of the company's sales are to retail stores throughout Asia. Bulk shipments are delivered to individual retail stores or to the corporate warehouse distribution facilities for chain stores. In 2013, Cho Books began marketing some of its products directly to schools. To do this, the company began sending out brochures to different schools, listing the telephone number of the company's local branch and directing school administrators to the company's Web site for more information. Using the Web site or the phone number, teachers and administrators can now easily access information about the books and order them directly from Cho. Cho's management decided to make this option available because they hoped that direct marketing will tap a new population of schools that do not have easy access to local retail stores. The company is also targeting schools that are currently buying Cho's products from retail stores but want to pay lower prices by buying materials wholesale.

Thus, the volume of shipments to retail stores is expected to drop slightly. Because Cho has had to expand the capabilities of its Web site to handle the new business, management has engaged an information technology consulting firm to update and maintain the online sales system. To simplify the system, all online sales are transacted through the use of credit cards. No other forms of payment are accepted.

Required

Before performing analytical procedures related to the payroll and personnel cycle accounts, develop expectations of how these recent events at Cho Books, Inc., will affect payroll expense for the following departments during 2011 compared to prior years. Indicate the degree (extensive, moderate, little) to which you expect the payroll expense account balance in each of the departments listed below to increase or decrease during 2013.

1. Warehouse and Shipping Department
2. IT Department
3. Accounts Receivable Department
4. Accounts Payable Department
5. Receiving Department
6. Executive Management
7. Marketing

18-30 (Objective 18-7) As part of the June 30, 2013, audit of accounts payable of Milner Products Company, the auditor sent 22 confirmations of accounts payable to vendors in the form of requests for statements. Four of the statements were not returned by the vendors, and five vendors reported balances different from the amounts recorded in Milner's accounts payable master file. The auditor made duplicate copies of the five vendors' statements to maintain control of the independent information and turned the originals over to the client's accounts payable clerk to reconcile the differences. Two days later, the clerk returned the five statements to the auditor with the information on the audit schedule following part c.

Required

a. Evaluate the acceptability of having the client perform the reconciliations, assuming that the auditor intends to perform adequate additional tests.
b. Describe the additional tests that should be performed for each of the five statements that included differences.
c. What audit procedures should be performed for the nonresponses to the confirmation requests?

Statement 1	Balance per vendor's statement	$ 6,618.01
	Payment by Milner on June 30, 2013	(4,601.01)
	Balance per master file	$ 2,017.00
Statement 2	Balance per vendor's statement	$26,251.80
	Balance per master file	(20,516.11)
	Difference cannot be located because the vendor failed to provide details of its account balance	$ 5,735.69
Statement 3	Balance per vendor's statement	$ 6,170.15
	Credit memo issued by vendor on July 15, 2013	(2,360.15)
	Balance per master file	$ 3,810.00
Statement 4	Balance per vendor's statement	$ 8,619.21
	Payment by Milner on July 3, 2013	(3,000.00)
	Unlocated difference not followed up because of minor amount	215.06
	Balance per master file	$ 5,834.27
Statement 5	Balance per vendor's statement	$ 9,618.93
	Invoices not received by Milner	(2,733.18)
	Payment by Milner on June 15, 2013	(1,000.00)
	Balance per master file	$ 5,885.75

18-31 (Objective 18-6) The physical inventory for Ajak Manufacturing was taken on December 30, 2013, rather than December 31, because the client had to operate the plant for a special order the last day of the year. At the time of the client's physical count, you observed that acquisitions represented by receiving report number 2631 and all preceding ones were included in the physical count, whereas inventory represented by succeeding numbers was excluded. On the evening of December 31, you stopped by the plant and noted that inventory represented by receiving report numbers 2632 through 2634 was received subsequent to the physical count but before the end of the year. You later noted that the final inventory on the financial statements contained only those items included in the physical count. In testing accounts payable at December 31, 2013, you obtain a schedule from the client to aid you in testing the adequacy of the cutoff. The following schedule includes the information that you have not yet resolved:

			INFORMATION ON THE VENDOR'S INVOICE		
Receiving Report Number	Amount of Vendor's Invoice	Amount Presently Included in or Excluded from Accounts Payable*	Invoice Date	Shipping Date	FOB Origin or Destination
2631	$4,256.40	Included	12-30-13	12-30-13	Origin
2632	6,320.54	Excluded	12-26-13	12-15-13	Destination
2633	3,761.22	Included	12-31-13	12-26-13	Origin
2634	7,832.18	Excluded	12-16-13	12-27-13	Destination
2635	6,847.77	Included	12-28-13	12-31-13	Origin
2636	6,373.58	Excluded	01-03-14	12-31-13	Destination
2637	5,878.36	Excluded	01-05-14	12-26-13	Origin
2638	3,355.05	Excluded	12-31-13	01-03-14	Origin

*All entries to record inventory acquisitions are recorded by the client as a debit to purchases and a credit to accounts payable.

Required

a. Explain the relationship between inventory and accounts payable cutoff.
b. For each of the receiving reports, state the misstatement in inventory or accounts payable, if any exists, and prepare an adjusting entry to correct the financial statements, if a misstatement exists.
c. Which of the misstatements in part b are most important? Explain.

CASE

18-32 (Objectives 18-2, 18-3, 18-4, 18-6) The following tests of controls and substantive tests of transactions audit procedures for acquisitions and cash disbursements are to be used in the audit of Ward Publishing Company. You concluded that internal control appears effective and a reduced assessed control risk is likely to be cost beneficial. Ward's active involvement in the business, good separation of duties, and a competent controller and other employees are factors affecting your opinion.

Ward Publishing Company—Part I
(See page 644 for Part II, and Case 19-28 on pages 667–668 for Part III)

Tests of Controls and Substantive Tests of Transactions Audit Procedures for Acquisitions and Cash Disbursements

1. Foot and cross-foot the acquisitions and cash disbursements journals for 2 months and trace totals to postings in the general ledger.
2. Scan the acquisitions and cash disbursements journals for all months and investigate any unusual entries.
3. Reconcile cash disbursements per books to cash disbursements per bank statement for 1 month.
4. Examine evidence that the bank reconciliation is prepared by the controller.
5. Inquire and observe whether the accounts payable master file balances are periodically reconciled to vendors' statements by the controller.
6. Examine the log book as evidence that the numerical sequence of checks is accounted for by someone independent of the preparation function.
7. Inquire and observe that checks are mailed by D. Ward or someone under his supervision after he signs checks.
8. Examine initials indicating that the controller balances the accounts payable master file to the general ledger monthly.
9. Select a sample of entries in the cash disbursements journal, and
   a. obtain related cancelled checks and compare with entry for payee, date, and amount and examine signature endorsement.
   b. obtain vendors' invoices, receiving reports, and purchase orders, and
      (1) determine that supporting documents are attached to vendors' invoices.
      (2) determine that documents agree with the cash disbursements journal.
      (3) compare vendors' names, amounts, and dates with entries.
      (4) determine whether a discount was taken when appropriate.
      (5) examine vendors' invoices for initials indicating an independent review of chart of account codings.
      (6) examine reasonableness of cash disbursements and account codings.
      (7) review invoices for approval of acquisitions by Ward.
      (8) review purchase orders and/or purchase requisitions for proper approval.
      (9) verify prices and recalculate footings and extensions on invoices.
      (10) compare quantities and descriptions on purchase orders, receiving reports, and vendors' invoices to the extent applicable.
      (11) examine vendors' invoices and receiving reports to determine that the check numbers are included and the documents are marked "paid" at the time of check signing.
   c. Trace postings to the accounts payable master file for name, amount, and date.
10. Select a sample of receiving reports issued during the year and trace to vendors' invoice and entries in the acquisitions journal.
   a. Compare type of merchandise, name of vendor, date received, quantities, and amounts.
   b. If the transaction is indicated in the acquisitions journal as paid, trace the check number to the entry in the cash disbursements journal. If unpaid, investigate reasons.
   c. Trace transactions to accounts payable master file, comparing name, amount, and date.

Required Prepare all parts of a sampling data sheet (such as the one in Figure 15-2 on page 507) through the planned sample size for the preceding audit program, assuming that a line item in the cash disbursements journal is used for the sampling unit. Use either nonstatistical or attributes sampling. For all procedures for which the line item in the cash disbursements journal is not an appropriate sampling unit, assume that audit procedures were performed on a nonsampling basis. For all tests of controls, use a tolerable exception rate of 5%, and for all substantive tests of transactions, use a rate of 6%. Use an ARACR of 10%, which is considered medium. Plan for an estimated population exception rate of 1% for tests of controls and 0% for substantive tests of transactions.

Prepare the data sheet using the computer (instructor option—also applies to Part II).

Part II

Assume a sample size of 50 for all procedures, regardless of your answers in Part I. For other procedures, assume that an adequate sample size for the circumstance was selected. The only exceptions in your audit tests for all tests of controls and substantive tests of transactions audit procedures are as follows:

1. Procedure 2—Two large transactions were identified as being unusual. Investigation determined that they were authorized acquisitions of fixed assets. They were both correctly recorded.
2. Procedure 9b(1)—A purchase order was not attached to a vendor's invoice. The purchase order was found in a separate file and determined to be approved and appropriate.
3. Procedure 9b(5)—Six vendors' invoices were not initialed as being internally verified. Three actual misclassifications existed. The controller explained that he often did not review codings because of the competence of the accounting clerk doing the coding and was surprised at the mistakes.

Required

a. Complete the sampling data sheet from Part I using either nonstatistical or attributes sampling.

b. Explain the effect of the exceptions on tests of details of accounts payable. Which balance-related audit objectives are affected, and how do those objectives, in turn, affect the audit of accounts payable?

c. Given your tests of controls and substantive tests of transactions results, write an audit program for tests of details of balances for accounts payable. Assume:
   (1) The client provided a list of accounts payable, prepared from the master file.
   (2) Acceptable audit risk for accounts payable is high.
   (3) Inherent risk for accounts payable is low.
   (4) Analytical procedure results were excellent.

RESEARCH PROBLEM 18-1: IDENTIFYING ACCOUNTS PAYABLE FRAUD

Organizations frequently use procurement cards (often referred to as P-Cards) to purchase goods or services using processes outside normal acquisition and cash disbursement procedures. P-Cards are a form of company charge card that are issued to approved employees who are expected to comply with company P-Card policies and operating procedures. In many cases, P-Cards replace petty cash funds used to make smaller purchases on short notice. While providing a number of conveniences for organizations, the use of P-Cards involves risks that should be addressed by internal controls. To learn more about effective P-Card policies and procedures, perform the following:

Required

a. Visit the *Fraud Magazine* Web site (www.fraud-magazine.com) and search for the November/December 2011 article "Preventing, Detecting, and Investigating Procurement Card Abuse" by using the search string "procurement card abuse."

b. Identify three preventative and three detective internal controls related to the use of P-Cards.

c. Briefly describe the purpose of each internal control identified in b.