



Chapter 10: Auditing the Expenditure Cycle

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Learning Objectives

- Understand the primary tasks associated with the expenditure cycle under different levels of technology.
- Understand audit objectives related to the expenditure cycle.
- Be familiar with expenditure cycle control issues related to alternative technologies.
- Recognize the relationship between expenditure cycle, audit objectives, controls, and test of controls.
- Understand the nature of substantive tests in achieving expenditure cycle audit objectives.
- Be familiar with common features and functions of ACL that are used to perform substantive tests.

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Purchases and Cash Disbursements: Batch Processing

- Data processing department - Step 1:
 - Process triggered by purchase requisition file created in revenue cycle when inventory fell to reorder point. Copies to purchasing.
- Receiving department clerk prepares a report when goods arrive with copies going to purchasing, AP and data processing.
- Data processing department - Step 2:
 - Batch job updates inventory subsidiary file, removes "on order" flag, closes PO file and calculates batch totals of receipts for GL update.
 - AP clerk reconciles invoice with supporting documents and prepares a cash disbursements voucher.

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Purchases and Cash Disbursements: Batch Processing

- Data processing department - Step 3:
 - Batch program validates voucher records against valid vendor file, adds a record to AP subsidiary file based on due date and prepares batch totals for posting to AP.
 - Checks printed daily based on due dates with each check recorded in the cash disbursements journal.
 - Batch totals of open and closed AP, inventory increases and cash disbursements posted to control accounts.
- Cash disbursements department clerk reconciles transaction list with checks, signs and mails them, sending a copy to AP.
- AP clerk matches document and closes file, concluding the expenditure cycle process.

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Integrated Purchases and Cash Disbursement System

- Departmental activity significantly reduced.
 - Computer programs perform many labor intensive clerical tasks which is cheaper and less error prone.
- Computer operations:
 - System reads purchase requisition file, validates vendors, prepares and sends POs, adds purchases to open PO file, and creates a digital transaction listing which is downloaded by the purchasing agent, reviewed and filed.
- Receiving department:
 - System adds records, matches quantities, closes PO, updates inventory subsidiary records and the GL inventory control account.

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Integrated Purchases and Cash Disbursement System

- Accounts payable department:
 - System links and reconciles invoice to PO and receiving report and creates a virtual AP packet.
 - Packet allows clerk to perform a 3-way match.
 - Payment is automatically approved if no issues found.
- Cash disbursements procedures:
 - After scanning due dates, checks automatically printed, signed and distributed to mail room.
 - System records payments, closes invoices, updates AP control and cash accounts and transmits reports to AP and cash disbursement departments for review and filing.

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Overview of Payroll Procedures

- Payroll check writing has unique risks, special controls needed to prevent and detect fraud.
- Periodic nature lends itself to batch processing.
 - Batch program calculates and posts payroll, prints paychecks, a fund transfer check, and a payroll register, and prepares records for posting.
 - Documents sent to cash disbursements where checks are reviewed, signed and sent to paymaster for distribution.
 - Fund transfer check reconciled with payroll register, signed and submitted for deposit.

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Reengineering the Payroll System

- Often integrated with **the human resource management (HRM)** system and differs from batch system:
 - Operational departments transmit transactions to data processing via terminals.
 - Direct access files used for data storage.
 - Many processes performed in real time.
- Key operating features:
 - Personnel department changes employee files in real time.
 - Cost accounting enters job data to create the **labor usage file**.
 - Timekeeping department creates **attendance file**.

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Reengineering the Payroll System

- Data processing performs the following in a batch process:
 - Labor costs are distributed to accounts.
 - Online labor distribution summary created.
 - Online payroll register created from the attendance file and **employee file**.
 - Employee records are updated.
 - Payroll checks are prepared and signed and sent to treasurer for reconciliation before distribution.
 - Disbursement voucher file updated and check prepared to fund the payroll imprest account.
 - GL updated.

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Expenditure Cycle Audit Objectives and Tests of Controls

- Input controls – Data validation:
 - Intended to detect transcription errors before transaction data are processed.
 - Most effective when performed as close to the source of transaction as possible.
- Testing validation controls:
 - Auditor may decide to rely on quality of other controls to provide assurance and reduce substantive testing.
 - If controls over systems development and maintenance are weak, auditor may test data editing controls.
 - Can achieve some degree of assurance by reviewing error listings and error logs.

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Expenditure Cycle Audit Objectives and Tests of Controls

- Input controls - Batch controls:
 - Used to manage high volumes of data through system.
 - Initiated at data input stage and continues through all phases of data processing.
- Testing batch controls:
 - Provide evidence relating to completeness and accuracy.
 - Involves reviewing transmittal records of batches processed and reconciling them to batch control logs.
- Input controls – Purchase authorization controls:
 - Occur in the revenue cycle when goods are sold to customers.

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Expenditure Cycle Audit Objectives and Tests of Controls

- Testing purchase authorization controls:
 - Provide evidence relating to accuracy and valuation.
 - Auditor needs to verify correct order quantity used when requisition is created and that inventory record is flagged on order when requisition is prepared.
- Input controls – Employee authorization:
 - Common frauds include submitting timecards on employees not employed by the firm and creating checks for “ghost” employees.
 - Someone in payroll should verify authorized employees.
 - When computerized, payroll program matches attendance records with personnel file.

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Expenditure Cycle Audit Objectives and Tests of Controls

- Testing employee authorization controls:
 - Provide evidence relating to existence, accuracy, valuation and rights and obligations.
 - Auditor needs to determine that effective procedures exist to identify employees and monitor adherence to authorization procedures.
 - Test can be performed by creating a dummy employee.
 - Must also obtain assurance that the authorized employee file has integrity.

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Expenditure Cycle Audit Objectives and Tests of Controls

- Process controls - File update controls:
 - Sequence check control needs to be in place to ensure proper sorting took place.
 - Liability validation control ensures liabilities are valid prior to payment.
 - **Valid vendor file** similar to authorized employee file.
 - Testing controls provide evidence of existence, completeness, rights and obligations and accuracy.

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Expenditure Cycle Audit Objectives and Tests of Controls

- Process Control -Access controls:
 - Prevent and detect unauthorized and illegal access to firm's assets and include warehouse security, moving assets promptly when received and paying employees by check vs. cash.
 - Controlling access to account records also important.
 - Risks include: processing fake AP, unauthorized paychecks, illegal disbursements and stolen products.

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Expenditure Cycle Audit Objectives and Tests of Controls

- Testing access controls:
 - Provides evidence of existence, completeness, accuracy, valuation and allocation, rights and obligations, classification, presentation and disclosure.
 - Purchase systems controls include segregation of duties, supervision, inspection and reconciliations.
 - Payroll system controls include **timecard** verification, supervision, an independent **paymaster** and a special **payroll imprest account**.

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Expenditure Cycle Audit Objectives and Tests of Controls

- Testing physical controls:
 - Inadequate segregation of duties and lack of supervision can result in fraud and errors that cause financial statements to be materially misstated.
 - Auditor's review of organizational structure should disclose egregious incompatible tasks.
 - In an automated environment, focus should be on the integrity of computer program performing tasks.
- Output controls:
 - Designed to ensure information is not lost, misdirected or corrupted and that system processes function as intended.

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Expenditure Cycle Audit Objectives and Tests of Controls

- Output controls:
 - Designed to ensure information not lost, misdirected or corrupted and system processes as intended.
 - Important element is audit trail maintenance including: accounts payable change reports, transaction logs and listings, logs of automatic transactions, unique transaction identifiers and error listings.
- Testing output controls:
 - Evidence relates to completeness and accuracy.
 - Involves reviewing reports and tracing transactions.
 - Modern systems store audit trails online as text file.
 - ITF system used to test output controls directly.

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Substantive Tests of Expenditure Cycle Accounts

- Risks and audit concerns:
 - Concern with potential understatement of liabilities and expenses.
 - Substantive tests directed towards evidence of understatement and omission, efficiency, fraud and losses due to overstatement errors.
 - Tests of internal controls and substantive tests.
- Understanding data:
 - Must understand systems and controls that produced data and characteristics of file that contain them.
 - Inventory, Purchase order, Purchase order line item, Payable report, Disbursement voucher and check register and file preparation procedures.

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Substantive Tests of Expenditure Cycle Accounts

- Testing the accuracy and completeness assertions:
 - Evidence relates to accuracy and completeness.
 - Review disbursement vouchers for unusual trends and exceptions.
 - Review for accurate invoice prices.
- Testing the completeness, existence, rights and obligations assertions:
 - Search for unrecorded liabilities.
 - Search for unauthorized disbursement vouchers.
 - Review for multiple checks to vendors.
 - Audit payroll and related records.

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Overview of Purchases and Cash Disbursements Activities

APPENDIX

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Purchase Processing Procedures

- Monitor inventory records:
 - When inventories drop to reorder point, a **purchase requisition** prepared and sent to prepare PO function.
- Prepare purchase order:
 - **Purchase order** prepared for each vendor with copy to the vendor, AP function and **open/closed PO file**. Inventory control function supplies info from inventory and valid vendor files.
- Receive goods:
 - Arriving goods reconciled with **blind copy** of PO that contains no quantity or price information.
 - Clerk prepares **receiving report** with copies to inventory, open/closed PO file, **AP pending file** and **receiving report file**.

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Purchase Processing Procedures

- Update inventory records:
 - When a **standard cost system** is used, inventories carried at standard rate, regardless of price paid.
 - Updating **actual cost inventory** ledger requires additional financial information such as invoice.
- Set up Accounts Payable:
 - Recognizing liability deferred until **supplier's invoice** arrives. Three-way match is done to reconcile it with receiving report and PO.
 - Transaction recorded in purchases journal and posted to supplier's account in **AP subsidiary ledger**.
 - Clerk transfers all source documents to **open AP file**.

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Vouchers Payable System

- Many firms use a **vouchers payable system**.
- AP department uses **cash disbursement vouchers** and maintains a voucher register. After three-way match, cash disbursement voucher prepared to approve payment.
- Vouchers improve control over cash payments and allows consolidate of payments to single vendor. Each voucher recorded in the **voucher register** with the sum of unpaid vouchers equal to AP liability.
- Voucher and other supporting documents filed in the **vouchers payable file** (equivalent to open AP file).
- GL function posts to inventory, AP control, and journal voucher file to complete the purchase phase.

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Cash Disbursement System

- Processes payment obligations created in the purchase system.
- Objective to ensure valid, correct payments made on a timely basis.
- Process begins in AP by identifying items due and sending payment approval to cash disbursements.
- Cash disbursement clerk receives documents, prepares and records checks in the **check register** (also called the **cash disbursements journal**), and sends a journal voucher to GL.
- Documents marked paid and returned to AP where records are updated with summary to GL.
- GL function receives voucher and summary, and updates GL records.

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Overview of Payroll Activities

- Personnel department:
 - Prepares and submits **personnel action forms** to prepare payroll function to reflect authorized employees and changes in records.
- Production department:
 - Prepares **job tickets** to capture time each employee spent on production jobs which are used to allocate direct labor charges to WIP accounts.
 - **Time cards** capture time employees are at work.
- Update WIP account:
 - After labor costs are allocated, charges are summarized in a **labor distribution summary** and forwarded to GL function.

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Overview of Payroll Activities

- Payroll clerk prepares payroll register, updates employee records, and prepares paychecks for distribution.
 - Many companies use an independent paymaster to prevent payments to nonexistent employees.
- Accounts Payable clerk reviews payroll register and prepares cash disbursement voucher for cash disbursements.
 - Single check prepared for amount of payroll.
- Update General Ledger:
 - Receives labor distribution summary, disbursement voucher and journal voucher and processes entries.

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