Auditing A Practical Approach

Third Canadian Edition

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Chapter 10

AUDITING PURCHASES, PAYABLES, AND PAYROLL

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LEARNING OBJECTIVES (1 of 2)

- 1. Identify the audit objectives applicable to purchases, payables and payroll
- Describe the functions and control procedures normally found in information systems for processing purchase, payment and purchase adjustment transactions
- 3. Describe the functions and control procedures normally found in information systems for payroll transactions

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LEARNING OBJECTIVES (2 of 2)

- Discuss considerations relevant to determining the audit strategy for purchases, payables, and payroll
- 5. Indicate the factors relevant to determining an acceptable level of detection risk for the audit of purchases, payables, and payroll
- 6. Design a substantive audit program for purchases, payables, and payroll

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Key Issues

- Purchases are all recorded and not understated
- Payables that are derived from the purchases are fully recorded as a liability
- Payroll expenses and the associated deductions and related liabilities are properly recorded as liabilities

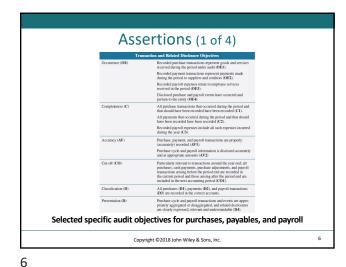
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Audit Objectives

- The audit objectives for purchases, payables, and payroll relate to obtaining sufficient appropriate evidence about each significant financial statement assertion for the applicable transactions and balances
- The next three slides show the main objectives for these transaction classes and account balances

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Account Balance and Related Disclosure Objectives Existence (OE) Recorded accounts payable represent amounts owed by the entity at the end of the reporting period (OES). Accrued payroll liability balances represent amounts owed at the end of the reporting period (OES). Rights and obligations (RO) Accounts payable (RO1) and accrued payroll liabilities (RO2) are liabilities of the entity at the end of the reporting period. Completeness (C) Accounts payable include all amounts owed by the entity to supplies or goods and services at the end of the reporting period. Accounts payable include all amounts owed by the entity to supplies or goods and services at the end of the reporting period (C4). Account payroll liabilities include all amounts owed in respect of payroll and deductions at the end of the reporting period (C5). Accounts payable, accrued payroll liabilities, and related expenses are properly identified and included in the tinancial statements (C6). Disclosures pertaining to commitments, contingent liabilities, and related party creditors are adequate (C7). (continued) Selected specific audit objectives for purchases, payables, and payroll

Accuracy, valuation and allocation (AV)

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Purchase Transactions (1 of 2)

- Purchase transactions relate to the purchase (from outside entities) of goods (including inventory and plant and equipment) and services (such as electricity and advertising)
- Payment transactions relate to the payment for such goods and services

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Purchase Transactions (2 of 2)

- The processing of purchase transactions involves the following functions:
 - requisitioning goods and services
 - preparing purchase orders
 - receiving the goods
 - storing goods received for inventory
 - checking and approving the supplier's invoice
 - · recording the liability

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Requisitioning Goods & Services

- Purchase requisition a document issued by an authorized person, detailing the goods and/or services required
- Requisitions are often pre-numbered, and indicate the general ledger code(s) for the purchase
- Once complete, the purchase requisition is then sent to the purchasing department

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Requisitioning and Ordering

The requisition and ordering functions should be separate, to reduce the opportunity for fraudulent orders and to improve efficiency through a centralized purchasing department

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Purchase Orders

- Purchase orders typically contain:
 - Description of goods/services ordered
 - Quantities
 - Price
 - Delivery Instructions
 - Supplier information
- Copies are distributed to: the supplier, receiving, accounting, and the requisitioner

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Receiving the Goods (1 of 2)

- Receiving should record the goods received, the quantity received, and inspect the goods for damage
- Segregation of receiving from both the requisition and purchasing functions aids in preventing direct ordering from suppliers plus reduces the chance of unauthorized access to goods improperly ordered

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Receiving the Goods (2 of 2)

- A pre-numbered receiving report should be prepared for each delivery with a copy to accounts payable
- Independent checks should take place periodically on the sequence of receiving reports

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Recording the Liability

- Suppliers normally send the invoice directly to the accounting department
- Prior to recording the supplier's invoice, the invoice should be checked for accuracy and approved

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Checking and Approving Invoices (1 of 2)

• Common procedures include:

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- Numbering supplier invoices to check that all invoices are recorded
- Three-way matching of supplier invoices invoices should be matched to the details of the receiving reports and purchase; this ensures only approved orders in the quantity received are paid for
- Check mathematical accuracy of invoice
- Code the accounting distributions on the supplier invoice

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Checking and Approving Invoices (2 of 2)

- · Common procedures include:
 - Approve invoices for payment by having the authorized person sign the invoice
 - Prepare a daily prelist of the suppliers' invoices approved for payment

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Recording the Liability (1 of 2)

- Approved suppliers' invoices are entered into the system
- Often computerized checks are made for supplier validity and reasonableness of amounts
- Once accepted the AP master file is updated and the invoice is added to the purchase journal

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Recording the Liability (2 of 2)

- The purchase journal then updates the applicable inventory and general ledger accounts
- Monthly supplier statements should be reconciled with the recorded supplier balances
- Periodic performance reviews by management should be made - comparing assets, liabilities, and expenses balances with budgeted amounts

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Payment Transactions (1 of 7)

- The two payments functions are:
 - paying the liability
 - recording the payments
- The same department or individual should not perform both these functions

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Payment Transactions (2 of 7)

- The AP department is responsible for payment of suppliers' invoices by their due date
- The computer system can be used to extract the payments due from the master file, produce cheques and a cheque register, and update the AP master file
- Cheques are reviewed by the AP department and matched with supporting documents prior to signing and then sending them out

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Payment Transactions (3 of 7)

- Common control related procedures include:
 - Authorized persons signing cheques should be segregated from those initiating or processing purchase transactions
 - Authorized signers should determine that each cheque/funds transfer is accompanied by proper documentation and that the payee and amount agree with the invoice

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Payment Transactions (4 of 7)

- Common control related procedures include (continued):
 - Suppliers' invoices and supporting documents should be cancelled to prevent payment resubmission
 - Cheque signers should control the mailing of the cheque or bank transfer initiation

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Payment Transactions (5 of 7)

- Common control related procedures include (continued):
 - No blank cheques or cheques payable to "cash" or "bearer" should be issued
 - · Pre-numbered cheques should used
 - Access to blank cheques and electronic signatures should be limited to authorized personnel

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Payment Transactions (6 of 7)

• When the cheque register in the computer system is updated, the program automatically produces the cash payments journal and a general ledger summary plus an update to the master files

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Payment Transactions (7 of 7)

- Payment recording procedures include:
 - Independent check by a supervisor of the agreement of the amount journalized/posted to the AP ledger with the cheque register received from the treasurer
 - Independently prepared bank reconciliations

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Payroll Transactions (1 of 11)

- The relevant functions for payroll are those of:
 - hiring employees
 - authorising payroll changes
 - preparing attendance and timekeeping data
 - preparing the payroll
 - · recording the payroll
 - paying the payroll and protecting unclaimed wages

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Payroll Transactions (2 of 11)

- All approved positions are documented on a personnel authorization form including the position classification and starting wage level
- A copy of this form is forwarded to payroll
- Data on all employees is entered into the personnel master file which is restricted by password to authorized individuals in the personnel department

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Payroll Transactions (3 of 11)

- A log is kept of all changes to this file
- This log should be reviewed periodically by a personnel manager not involved in the data entry process

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Payroll Transactions (4 of 11)

- Segregation of the personnel and payroll functions aids in reducing the risk of payments to fictitious employees
- Any change to job classifications or a wage increase must authorized and submitted to the personnel department in writing before the change can be entered into the master file

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Payroll Transactions (5 of 11)

- A termination notice is issued by the personnel department upon completion of an individual's employment
- A copy of this notice is promptly sent to the payroll department

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Payroll Transactions (6 of 11)

- Time-recording details such as hours are manually or electronically entered into the payroll file from approved sources
- These payroll transactions are often subject to supervisory review and approval

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Payroll Transactions (7 of 11)

- The payroll calculations are performed and recorded in detail in the payroll transaction files
- Using the calculated items (such as gross pay, deductions, and net pay) the employee payroll records and accumulated totals for the payroll journal entry are generated and entered in the general ledger master file

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Payroll Transactions (8 of 11)

 A payroll register is then produced containing details of wages paid, taxes withheld, and a cumulative record of wages paid

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Payroll Transactions (9 of 11)

- At regular internals a review is conducted by appropriate personnel of:
 - Exception reports
 - Payroll register copy returned to the payroll department
 - Payroll register, payroll cheques/electronic transfers sent to the finance office
 - General ledger summary sent to accounting

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Payroll Transactions (10 of 11)

- Common control procedures include:
 - Finance officer reviews the agreement of names and amounts on cheques/bank transfers with payroll register entries
 - Payroll cheques/bank transfers should be signed/authorized by finance office personnel not involved with the preparation or recording of payroll

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Payroll Transactions (11 of 11)

- Common control procedures include (continued):
 - Payroll cheques if used should be distributed by finance office personnel who should require proper identification of employees
 - Unclaimed cheques should be safely stored
 - Use of an impressed payroll bank account

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Audit Strategy

- Need to obtain an understanding of the entity and its environment in order to assess inherent and control risk
- The auditor then determines the audit strategy and plans an appropriate mix of tests of controls and substantive procedures
- Tests of controls confirm (or otherwise) the auditor's preliminary assessment of control risk by testing operating effectiveness

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Entity and Environment

- Developing an understanding of the entity and its environment will assist the auditor in developing:
 - An understanding of cost of sales and gross margins
 - An understanding of levels of various types of expenses
 - Developing an expectation of payables levels

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Analytical Review

- Used during the risk assessment phase to help identify high risk areas
- Enables the auditor to compare expectations to actual financial statement elements
- Examples include investigation and comparison of:
 - · Gross margins and net margins
 - Expected staffing costs
 - Payable days

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Inherent Risk (1 of 2)

- Purchase and payroll expenses account are major expenses incurred by a business
- Auditors need to consider:

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- Pressure to understate expenses in order to meet targets or industry norms
- Pressure to understate payments in order to report a higher level of working capital due to liquidity problems or going concern doubts

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Inherent Risk (2 of 2)

- Auditors need to consider (continued):
 - · High volume of transactions
 - Temptation for employees to make unauthorized purchases and payments or to misappropriate purchase assets for personal use
 - Contentious accounting issues (i.e., capitalization vs. expense of repairs)
 - Complexity of payroll calculations for those based upon time and/or productivity

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 Factors relating to the control environment that auditors need to consider when evaluating control risk in this area include:

Internal Controls

- Integrity and ethical values
- Pressure from suppliers such as offers of kickbacks
- Management's commitment to competence of personnel
- Assignment of authority and responsibility

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Control Risk (1 of 2)

- After obtaining an understanding of the internal control structure, the auditor forms a preliminary assessment of control risk
- If control risk is deemed low, tests of the operating effectiveness of controls are then done to confirm this preliminary assessment made.

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Control Risk (2 of 2)

- Computer testing may be used in performing tests of controls
- A few examples include: searching supplier invoices for invalid classifications, missing numbers or unreasonable amounts, and sample selection
- Samples of a few control risk programs are included on the next few slides for purchases and payroll

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CR Assessment - Purchase Transactions (1 of 2) Relevant Class of Transactions Audit Objective of Operations (1 of 2)

Function	wcgw	Necessary Control	Possible Test of Operating Effectiveness	Transactions Audit Objective (from Table 10.1)				
				OE1	C1	AV1	CO	D1
Requisitioning goods and services	Goods may be requisitioned for unauthorized purposes.	General and specific authorization procedures	Inquire about procedures. Review documents for evidence of approvals.	1				
Preparing purchase orders	Purchases may be made for unauthorized purposes.	Approved purchase requisition for each order	Examine purchase orders for approved requisitions.	1				
Receiving goods	Goods received may not have been ordered.	Approved purchase order for each shipment	Examine receiving report for matching purchase order.	1				
	Incorrect quantities, damaged goods, or incorrect items may be received.	Receiving clerks to count, inspect, and compare goods received with purchase order	Observe the performance by receiving clerks.	1				
Storing goods received for inventory	Inventory clerks may deny taking custody of purchased goods.	Signed receipt to be obtained on delivery of goods from receiving to inventory	Inspect signed receipts.	1				

 ${\bf Control\ risk\ assessment\ considerations-purchase\ transactions}$

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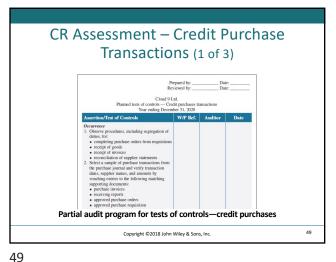
CR Assessment - Purchase Transactions
(2 of 2)

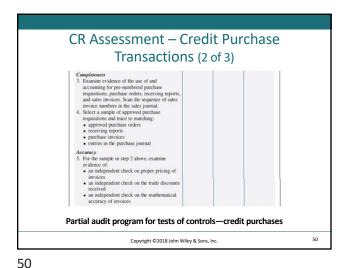
| Function | WCCW | Necessary Control | Possible Test of Operating | Effectiveness | DEL Control | Possible Test of Operating | Effectiveness | DEL Control | Possible Test of Operating | Effectiveness | DEL Control | Possible Test of Operating | Effectiveness | DEL Control |

Control risk assessment considerations—purchase transactions

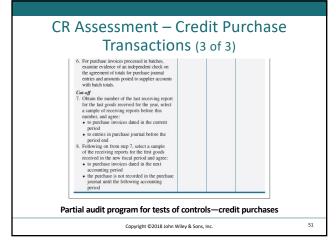
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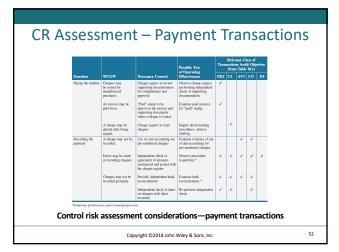
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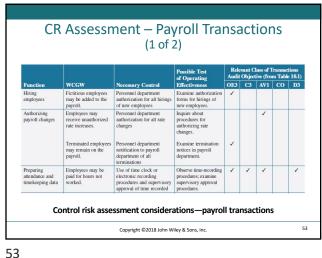


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CR Assessment – Payroll Transactions (2 of 2)Control risk assessment considerations—payroll transactions Copyright ©2018 John Wiley & Sons, Inc.

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Determining An Acceptable Level of **Detection Risk**

- After assessing the IR and CR, detection risk is set to achieve the required audit risk
- Detection risk is then used to determine the nature, timing, and extent of substantive procedures
- If detection risk is set at low, then extensive substantive testing will take place
- If detection risk is set at high, then a combined approach will be used

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Substantive Procedures (1 of 2)

- Accounts payable is usually the largest current liability in a balance sheet and a significant factor in the evaluation of an entity's short-term solvency
- Is generally affected by a high volume of transactions and thus is susceptible to misstatements
- The auditor is primarily concerned with understatement of payables

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Substantive Procedures (2 of 2)

Considerations

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- Management may understate payables in order to report a more favourable financial position
- Thus, the audit of payables places more emphasis on gathering evidence about the completeness assertion than the existence assertion

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Initial Procedures (1 of 2)

The auditor performs initial procedures on payables balances and records by:

- Tracing the opening balance for payables to the previous year's working papers
- Reviewing activity in the general ledger account for payables, and investigating entries that appear unusual in amount or source

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Initial Procedures (2 of 2)

- · The auditor obtains a listing of accounts payable at balance date:
 - adds the listing and determines agreement with the total of the subsidiary ledger and the general ledger control account balance
 - tests the agreement of suppliers and balances on the listing with those included in the underlying accounting records

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Analytical Procedures (1 of 2)

- Compare current and previous year balances
- Calculate significant ratios; potential examples include:
 - gross profit

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- accounts payable turnover
- each expense compared to sales
- average wage per employee
- · Obtain explanations for unexpected changes

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Analytical Procedures (2 of 2)

- Corroborate explanations
- Analytical procedures are significant in achieving the desired level of detection risk for payroll balances
 - e.g., average wage per employee and payroll expenses as a percentage of sales

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Tests of Details of Transactions (1 of 2)

Procedures followed by the auditor include:

- Vouching a sample of purchase transactions to supporting documentation
- Vouching credits to supporting suppliers' invoices, receiving reports and purchase orders, or other supporting documents
- Vouching debits to payments

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Tests of Details of Transactions (2 of 2)

Performing purchases and payments cut-off tests

- Checking subsequent payments between the balance date and the end of fieldwork
- Investigating unmatched purchase orders, receiving reports and suppliers' invoices at the year end

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Tests of Details of Balances (1 of 2)

- The three tests included in this category for payables are:
 - reconciling payables to monthly statements received by the entity from suppliers
 - · confirming accounts payable
 - searching for unrecorded liabilities

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Tests of Details of Balances (2 of 2)

- The two tests for payroll balances are:
 - recalculating payroll liabilities

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- verifying directors' and executive officers' remuneration
- executive remuneration will be reviewed by reference to employment contracts and board minutes

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