Chapter 18

Audit of the Acquisition and Payment Cycle: Tests of Controls, Substantive Tests of Transactions, and Accounts Payable

- **Concept Checks**

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1. There are several balance sheet and income statement accounts related to the acquisition and payment cycle as shown in Figure 18-1. The most significant balance sheet accounts are cash in bank; property, plant, and equipment; accounts payable; and other accrued liabilities. The most significant income statement accounts are COGS accounts (including purchases), depreciation expense, income tax expense, and other possibly significant accounts such as administrative expense, rent expense, repairs and maintenance, or legal expense.

2. A voucher is a document used by an organization to establish a formal means of recording and controlling acquisitions. A voucher register is a journal for recording the vouchers for the acquisition of goods and services. The use of a voucher system improves control over the recording of purchases by facilitating the recording in numerical order at the earliest possible date, which is the point at which the invoice is received.

3. The point at which goods and services are received is ordinarily when title to the goods and services passes and a liability that should be included in the financial statements is established.

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1. The acquisition and payment cycle includes the recording of liabilities that are set up in the accounts payable account. If the auditor finds that the internal controls in the acquisition and payment cycle are sufficient to ensure that accounts payable are recorded in the proper amount and at the proper time, reconciling the vendors' statements and testing the cutoff as year-end procedures of the accounts payable balance may be greatly reduced.

2. It is important that the cutoff of accounts payable be coordinated with that of the physical inventory to determine that they are established at the same point in time. If these cutoffs are not consistent, goods may be counted in the physical inventory for which no liability in accounts payable has been

recorded, or vice versa. Such a situation would result in an understatement of accounts payable and cost of goods sold or an overstatement of these two accounts, respectively. During the physical inventory, the auditor should gather cutoff information (such as the last several receiving reports and shipping documents) to assist in the determination that an accurate cutoff was established.

3. To test for completeness of accounts payable, the auditor conducts various out-of-period liability tests (also called a search for unrecorded accounts payable) designed to uncover unrecorded accounts payable. These tests include examining underlying documentation for cash disbursements occurring subsequent to year-end and verifying that a liability is recorded at year-end if appropriate; examining underlying documentation for bills that are still not paid several weeks after year-end; tracing receiving reports issued before year-end to the related vendors' invoices and making sure they are included in accounts payable; examining vendors' statements as of year-end and tracing to accounts payable; and sending confirmations to vendors with which the client does business.

■ Review Questions

18-1 The accounts in the acquisition and payment cycle are the following:

a. Asset accounts:

- Office supplies
- Delivery equipment
- Machinery and equipment
- Land
- Cash in bank
- Prepaid expenses

b. Liability accounts:

- Accounts payable
- Accrued property taxes
- Accrued insurance
- Other accrued liabilities

c. Expense accounts:

- Purchases, purchase returns & allowances, purchases discounts (COGS accounts)
- Rent expense
- Legal expense

18-1 (continued)

- Fines and penalties
- Advertising expense
- Repairs and maintenance
- Depreciation expense
- Utilities expense
- Property tax expense
- Administrative expenses
- Income tax expense

18-2 A vendor's invoice is sent with or at the same time as the order and states the amount of goods shipped, the price, and other details. This is the vendor's bill for the goods shipped. A vendor's statement contains the individual open items and the ending balance due in the account. A vendor's statement is not as meaningful as an invoice to verify individual transactions because a statement includes only the total amount of the transactions and not the details making up the shipment, such as unit price and freight. The vendor's statement can be used to verify the correct balance in accounts payable for an individual vendor. The statement contains the ending balance and the individual transactions required to reconcile the accounts payable listings and determine the propriety of the balances shown for individual vendors.

18-3 It is difficult to control blank or voided checks (as well as checks issued before they are mailed) without having a printed prenumbered system of blank checks. Without prenumbering, unauthorized and unrecorded checks may be more easily issued without detection until after they have cleared the bank. The auditor can compensate for poor control over checks by reconciling recorded cash disbursements with cash disbursements on the bank statement for a test period.

18-4

TRANSACTION-RELATED AUDIT OBJECTIVE	POSSIBLE INTERNAL CONTROLS	COMMON TESTS OF CONTROLS
1. 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. ■ Supporting documentation is examined before signing of checks by an authorized person. ■ Approval of payment noted on supporting documents at the time checks are signed.	■ Discuss with personnel and observe activities. ■ Discuss with personnel and observe activities. ■ Examine indication of approval.
2. 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.
3. 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 recon-ciliations and observe their preparation.
4. Cash disbursement transactions are properly included in the accounts payable master file and are properly 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.
5. Cash disbursement transactions are properly 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.
6. 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. ■ Dates are internally verified.	■ Examine procedures manual and observe whether unrecorded checks exist. ■ Examine indication of internal verification.

18-5

TRANSACTION-RELATED AUDIT OBJECTIVE	POSSIBLE INTERNAL CONTROLS	COMMON TESTS OF CONTROLS
1. 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.
2. 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.
3. 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.
4. Acquisition transactions are properly included in the accounts payable and inventory master files, and are properly 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.

18-5 (continued)

TRANSACTION-RELATED AUDIT OBJECTIVE	POSSIBLE INTERNAL CONTROLS	COMMON TESTS OF CONTROLS
5. Acquisition transactions are properly classified (classification).	■ Adequate chart of accounts is used. ■ Account classifications are internally verified.	■ Examine procedures manual and chart of accounts. ■ Examine indication of internal verification.
6. 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.

18-6 Auditing standards require that the tests of controls and substantive tests of transactions cover the entire accounting period in order to determine that the system was operating in a consistent manner throughout the period. In selecting the number of items for testing, the auditor must determine the sample size, statistically or nonstatistically, such that it is likely to be representative of the actual conditions of the population of all transactions during the entire period.

In testing items that are periodic procedures rather than individual transactions (such as monthly bank reconciliations), the auditor must determine the appropriate timing to determine that those procedures are operating properly.

18-7 The importance of cash discounts to the client is that the client can produce a substantial savings if it makes use of the cash discounts available. The auditor should examine vouchers and invoices to determine whether discounts are being taken in accordance with the terms available.

18-8 The difference in the purpose of the steps is that Procedure 1 ascertains whether all existing acquisitions are recorded properly (completeness and accuracy), whereas Procedure 2 is designed to determine whether recorded acquisitions are proper (occurrence and accuracy). Although the two procedures test opposite objectives (completeness and occurrence), they are similar in that each is designed to determine that the vendor's name, type of material and quantity purchased, and total amount of the acquisition agree with the receiving report, vendor's invoice, and acquisitions journal entries.

18-9 The acquisition and payment cycle is related to the inventory accounts in that normally all purchases of raw materials in the case of a manufacturing operation or merchandise in the case of a distribution or retail company are recorded through this cycle. If the tests of internal controls of the acquisition and payment cycle indicate that proper controls exist to ensure that the proper cost is used in valuing the inventory and that new purchases of inventory are recorded at the proper time, in the proper amount, and in the proper account, tests concerned with the accuracy and cutoff of the inventory accounts may be reduced from that level required if the controls were not adequate.

18-10 In order to streamline ordering and purchasing, many businesses electronically link their internal accounting systems to suppliers' systems. By sharing information electronically, suppliers can access inventory records to anticipate an order, or plan their own production schedule, or suppliers can access accounts payable records to monitor the status. When suppliers have access to a company's inventory and payables systems, IT risks increase as well as the risk of material misstatements if IT controls at the supplier are ineffective. Sharing of information through networks or e-commerce systems also exposes sensitive company data as well as software and hardware systems to potential cybersecurity risks.

Companies may also make changes in the way inventory physically moves through the supply or distribution channel. For example, a company may move from purchasing from a centralized warehouse to purchasing from regional distribution centers. Changes in the supply and distribution channels may make it more difficult to track inventory movements, increasing the risk of cutoff errors in inventory and accounts payable.

18-11 The following are substantive analytical procedures related to purchases and accounts payable, and the possible misstatements that may be uncovered.

Substantive Analytical Procedure	Possible Misstatement
Compare acquisition-related expense account balances with prior years	Misstatement of expenses and account payable
Calculate the ratio of purchases to accounts payable, and compare with prior year	Unrecorded or nonexistent accounts, or misstatements
Compare individual accounts payable with previous years	Unrecorded or nonexistent accounts, or misstatements
Review purchases by month and compare trends with prior year	Misstatement (overstatement or understatement) of expenses

18-12 The procedure will most likely uncover the misstatement in item b. The search for unrecorded invoices is designed to detect an understatement of accounts payable.

18-13 Unless evidence is discovered that indicates that a different approach should be followed, auditors traditionally follow a conservative approach in selecting vendors for accounts payable confirmations and customers for accounts receivable confirmations. The auditor assumes that the client is more likely to understate accounts payable, and therefore concentrates on the vendors with whom the client deals actively, especially if that vendor's balance appears to be lower than normal on the client's accounts payable listing at the confirmation date. In verifying accounts receivable, the auditor assumes that the client is more likely to overstate account balances, and for that reason concentrates more on the larger dollar balances and is not as concerned with "zero balances."

18-14 There are several reasons why it is not as common to confirm accounts payable at an interim date as it is for accounts receivable:

- Less reliance is placed on accounts payable systems than accounts receivable systems for most audits. For accounts payable, it is common to rely heavily on the search for unrecorded accounts payable to test the balance. When control risk is assessed at the maximum, it is inappropriate to confirm at an interim date.
- In auditing accounts payable, it is common for the auditor to confirm only those accounts for which vendors' statements are not available (received by the client) at year-end. Hence, the auditor will not know which accounts will be confirmed until the end of the year.
- Accounts payable confirmation is usually a less important and less time-consuming task than confirmation of receivables; therefore, it is less important to confirm the accounts payable early for purposes of reducing year-end audit time.

18-15 F.O.B. destination means that the title to the goods passes when they are received by the purchaser. F.O.B. origin signifies that the title passes to the buyer when the goods are shipped by the seller.

The auditor should be aware that the client might receive inventory subsequent to year-end that legally was the property of the client at year-end. When receiving reports near year-end are being examined and tested in connection with inventory cutoff tests, the auditor should search for goods that were shipped prior to year-end F.O.B. origin and received after the closing date. Examination of bills of lading will substantiate the date of shipment.

■ Multiple Choice Questions From CPA Examinations

18-16 a. (2) b. (4) c. (4)

18-17 a. (3) b. (3) c. (3) d. (1)

■ Multiple Choice Questions From Becker CPA Exam Review

18-18 a. (2) b. (3) c. (4)

■ Discussion Questions and Problems

18-19

QUESTION	a. TRANSACTION-RELATED AUDIT OBJECTIVE(S)	b. TEST OF CONTROL	c. POTENTIAL MISSTATEMENT(S)	d. SUBSTANTIVE PROCEDURE
1	Recorded acquisitions and payments are for goods and services received, consistent with the best interests of the client (occurrence).	Observe and inquire about personnel performing purchasing, shipping, payables, and disbursing functions.	Goods received and not recorded or recorded and not received. Disbursements made for goods not received.	Vendor statement reconciliation. Review of physical inventory shortages.
2	Existing acquisitions are recorded (completeness).	Account for numerical sequence of receiving reports and determine that all were recorded.	Receiving reports are misplaced and acquisitions not recorded.	Vendor statement reconciliation.
3	Acquisitions are recorded on the correct dates (timing). Existing acquisitions are recorded (completeness).	Observe and inquire about the procedure performed by mail clerk. Compare date mail is received to date accounting received invoices.	Late recording or non-recording of liabilities to suppliers.	Vendor statement reconciliation. Search for unrecorded liabilities.

18-19 (continued)

QUESTION	a. TRANSACTION-RELATED AUDIT OBJECTIVE(S)	b. TEST OF CONTROL	c. POTENTIAL MISSTATEMENT(S)	d. SUBSTANTIVE PROCEDURE
4	Acquisition transactions are properly classified (classification).	Examine indication of approval.	Acquisitions are recorded in the wrong account.	Examine supporting invoice for reasonableness of accounting distribution.
5	Acquisitions are recorded at the proper amounts (accuracy).	Examine cancelled invoices for indication of checking for clerical accuracy.	Acquisitions from vendors are recorded at improper amounts.	Test extensions, footings, discounts, and freight terms on vendors' invoices.
6	Payments are recorded on the correct dates (timing). Existing payments are recorded (completeness).	Observe whether the system automatically posts checks when they are prepared.	Checks are disbursed and not recorded or they are recorded in the wrong time period.	Examine checks clearing the bank prior to year-end to determine that they were recorded in the cash disburse-ments journal prior to year-end.
7	Acquisitions are for goods and services received, consistent with the best interests of the client (occurrence).	Examine invoices for which checks have been disbursed to determine that they have been cancelled.	Invoices are recorded and paid more than once.	Examine vendor statements, noting any unrecorded payments appearing on the statement.
8	Recorded cash disbursements are for goods and services actually received (occurrence).	Observe and inquire about the handling of checks from the time they are mailed to suppliers.	Checks are disbursed and no merchandise is received. Checks are received by someone other than the supplier for whom they are intended.	Trace checks to supporting invoice and determine reasonableness of expenditure. Reconcile vendors' statements.

18-20

AUDIT PROCEDURE	a. TYPE OF EVIDENCE	b. TRANSACTION AUDIT OBJECTIVE	c. TEST OF CONTROL OR SUBSTANTIVE TEST OF TRANSACTION
1.a.	Inspection	Recorded acquisitions and payments are for goods and services received, consistent with the best interests of the client (occurrence).	Test of control
1.b.	Inspection	Recorded acquisitions and payments are for goods and services received, consistent with the best interests of the client (occurrence).	Test of control
1.c.	Inspection	Recorded acquisitions and payments are for goods and services received, consistent with the best interests of the client (occurrence). Acquisitions are recorded at the proper amounts (accuracy).	Test of control
1.d.	Recalculation	Acquisitions are recorded at the proper amounts (accuracy).	Substantive test of transaction
1.e.	Reperformance	Acquisition transactions are correctly included in the accounts payable master file and are correctly summarized (posting and summarization).	Substantive test of transaction
1.f.	Inspection	Acquisitions are recorded on the correct dates (timing).	Substantive test of transaction
1.g.	Inspection	Acquisition transactions are properly classified (classification).	Substantive test of transaction

18-20 (continued)

AUDIT PROCEDURE	a. TYPE OF EVIDENCE	b. TRANSACTION AUDIT OBJECTIVE	c. TEST OF CONTROL OR SUBSTANTIVE TEST OF TRANSACTION
2.	Inquiry	Recorded acquisitions and payments are for goods and services received, consistent with the best interests of the client (occurrence). Acquisitions are recorded at the proper amounts (accuracy). Acquisitions are recorded on the correct dates (timing).	Test of control
3.	Analytical procedure	Recorded acquisitions and payments are for goods and services received, consistent with the best interests of the client (occurrence). Acquisitions are recorded at the proper amounts (accuracy).	Substantive test of transaction
4.	Recalculation	Acquisition transactions are correctly included in the accounts payable master file and are correctly summarized (posting and summarization).	Substantive test of transaction
5.	Inspection	Existing acquisitions are recorded (completeness).	Substantive test of transaction

18-21 a. Here are advantages for purchasing raw material jewelry items online through supplier Web sites:

- *Increased Product Selection*. Donnen Design purchasing personnel may be able to locate new products only offered through the Internet that they may not be able to obtain through normal purchasing channels.

- *Faster Delivery of Purchases*. Because Donnen Designs purchasing agents may be able to purchase raw material jewelry items with company credit cards, shipment of the products to Donnen warehouses can occur at the point of sale. Thus, raw materials may be received by Donnen more quickly.
- *More Product Information*. Most jewelry suppliers post pictures of the products for sale on the Internet. Thus, Donnen purchasing personnel may have greater opportunities to pre-screen items before purchase than they do through traditional ordering sources.

b. Here are potential risks associated with online purchases of raw material jewelry items:

- *Unauthorized Purchases Using Donnen Credit Cards*. Given that all online sales must be made using a company credit card, purchasing agents may have an opportunity to make unauthorized purchases that are charged to Donnen credit cards but shipped to purchasing agent addresses.
- *Privacy Protection for Donnen Credit Cards*. Because the reputation of the online vendors is unknown, there is some risk that Donnen credit card information will not be adequately protected by vendors from unauthorized use.
- *Inconsistent Product Quality*. Because Donnen purchasing agents will be buying products from a wide variety of new vendors, they have less information about product quality across vendors. As a result, the quality of the products purchased may vary extensively.
- *Reliability of Supplier*. Because Donnen purchasing agents will be buying products from a wide variety of new vendors, the reliability of those suppliers may vary extensively. There is no certainty that orders placed with each vendor will be processed completely and accurately.

c. The primary advantage of allowing Donnen Designs purchasing agents to acquire products using company credit cards is that the products will be shipped and delivered on a more timely basis than if they pay by company check.

d. The primary advantages of restricting purchases to only those that can be paid by company check are that it (1) decreases the risk that Donnen personnel use company credit cards to make unauthorized purchases and (2) decreases the risk that online vendors fail to adequately protect Donnen credit card information.

18-21 (continued)

e. Suggested internal controls:

(1) To prevent purchasing agents from making unauthorized purchases of non-jewelry items using Donnen credit cards, the company could:

- Request through the credit card agency that only selected types of products are authorized for purchase (for example, the credit card would not be allowed for any services, such as travel, food, hotel, etc.).
- Send all credit card billing statements directly to accounting for reconciliation to receiving reports of inventory products.
- Separate credit cards may be issued to purchasing personnel with pre-specified spending limits.

(2) To prevent purchasing agents from ordering jewelry items for shipment to an agent’s home address, the company could:

- Send all credit card billing statements directly to accounting for reconciliation to receiving reports.
- Only allow purchases from selected online vendors whose policies indicate that products may only be shipped to the credit card billing address (which would be a Donnen Design address).

(3) To prevent a buildup of unused credits with online vendors for returned goods, the company could:

- Only allow purchases from selected online vendors whose policies indicate that products may be returned for credit to the credit card account.
- Pre-screen product quality from all vendors before authorizing the use of that vendor for online purchasing.
- Establish purchasing limits for each online vendor so that the amount of purchases at a single vendor are not excessive.

18-22 a. The employees in this large government agency were purchasing expensive items such as appliances, electronics, and even vehicles, for themselves using agency funds. The fraud was perpetrated by employees ordering goods from a particular vendor, who then never shipped the goods, but provided kickbacks to the government agency employees. The internal control deficiencies that allowed this scheme to continue for several years included the following:

- An understaffed internal audit function
- The agency had a reactive approach to fraud detection and prevention rather than a proactive approach
- The internal control requirement that all purchases exceeding $2,500 required an approved purchase order was easy to circumvent

The incentives of the agency employees to commit fraud included the following:

- The agency would lose any budget money that was not spent by the end of the year, so this provided an incentive for employees to spend until they reached the budget limit.
- The employees personally gained by receiving expensive items in exchange for "purchasing" goods from the vendor participating in the fraud.

b. Data analytics can be used to detect fraud by enabling the auditor to analyze large datasets more easily and to drill down into the data. The auditor can easily disaggregate purchases by month, by vendor, or by amounts that are close to a spending limit. The auditor can examine trends in each of these areas as well. For example, in this particular case, the fraud examiner noted that payments to the vendor in question increased 342 percent in one year.

c. A fraud examiner could perform the following comparisons in order to detect fraud related to a particular vendor:

- Calculate year-to-year percentage changes in total purchases from each vendor.
- If there are multiple employees making purchases, calculate the percentage of purchases made by each employee to each vendor. This may identify cases where one particular employee seems to make excessive purchases from a particular vendor, suggesting collusion.
- If there is a spending limit, or a limit on the purchases that can be made without a purchase order or supervisor approval, examine purchases by vendor that are close to the spending limit.
- Compare purchasing records to receipt of goods or services to ensure all purchases are subsequently received.

18-23

EXCEPTION	a. TYPE OF EXCEPTION	b. TRANSACTION-RELATED AUDIT OBJECTIVE NOT MET	c. AUDIT IMPORTANCE	d. FOLLOW-UP	e. EFFECT ON AUDIT	f. PREVENTIVE CONTROLS
1	Monetary misstatement	Recorded cash disbursement transactions are correctly stated (accuracy).	Results in $100 liability, which may or may not be recorded on the books.	Investigate the exception rate to determine the possible effect of unrecorded liabilities on the financial statements.	Probably none, since occurrence rate is low. If amount is significant, then expansion of reconciliation of vendor statements may be appropriate.	An independent person should compare checks to invoice amount prior to signing checks.
2	Control deviation	Existing cash disbursement transactions are recorded (completeness).	The check may not actually have been voided. It could represent the disbursement of cash if a check was prepared.	Determine company policy for voided checks and evaluate the potential for unrecorded checks.	Auditor should examine the bank cutoff statement for the possibility that the voided check and other checks may have been issued and cashed but not recorded.	Require that all voided checks be properly voided and saved.

18-23 (continued)

EXCEPTION	a. TYPE OF EXCEPTION	b. TRANSACTION-RELATED AUDIT OBJECTIVE NOT MET	c. AUDIT IMPORTANCE	d. FOLLOW-UP	e. EFFECT ON AUDIT	f. PREVENTIVE CONTROLS
3	Monetary misstatement	Recorded cash disbursements are for goods and services actually received (occurrence).	It could be a fraudulent payment or it could result in an over-statement of perpetual inventory records. If the payment is fraudulent, there are serious audit ramifications. If it is unintentional, the situation is wasteful of company assets and must be brought to the client's attention.	First determine whether it is fraudulent. If not, investigate the frequency of occurrence of duplicate payments to determine their significance.	The duplicate payments result in recording of nonexistent inventory. If the company performs an interim physical inventory, the auditor could experience a problem relying on the system of internal control between the physical inventory date and year-end.	Invoices must be matched with an original receiving report and purchase order prior to approval for payment. All duplicate invoices are marked "duplicate" upon receipt.
4	Monetary misstatement	Acquisition transactions are properly classified (classification).	Indicates that no one is effectively reviewing the accounting distribution. Auditor must consider the effect of the exceptions on determining the amount of reliance that he or she may place on the system.	Determine the significance of the misclassifications and plan any required additional steps that are deemed appropriate.	If considered significant, the exceptions could prevent reliance on the system of internal controls and require the auditor to perform additional tests of the classification of items within the financial statements.	Have someone review the account distribution of invoices that enter the system.

18-23 (continued)

EXCEPTION	a. TYPE OF EXCEPTION	b. TRANSACTION-RELATED AUDIT OBJECTIVE NOT MET	c. AUDIT IMPORTANCE	d. FOLLOW-UP	e. EFFECT ON AUDIT	f. PREVENTIVE CONTROLS
5	Control deviation	Recorded acquisitions and related cash disbursements are for goods and services received, consistent with the best interests of the client (occurrence).	Indicates that the controller is not following the procedure of initialing invoices. This may indicate that he or she is not effectively reviewing invoices and other supporting documents prior to payment.	Determine whether or not the controller is effectively reviewing invoices and other supporting documents.	If determination is made that controller does not review supporting documents, the audit tests should be increased to determine the significance of the deficiency.	A competent independent person should review supporting documents for approval of controller and test items to determine effectiveness of controller's review.
6	Monetary misstatement	Acquisition transactions are recorded on the correct dates (timing).	At the date of the physical inventory, this situation will be critical in that any items counted in physical inventory and not recorded in the acquisitions journal will cause an understated cost of sales and accounts payable.	Determine whether or not this situation persists throughout the year and whether it is rectified at physical inventory date and year-end.	Require expansion of purchase cutoff work at physical inventory date and year-end.	Require that copies of all receiving reports be routed directly to accounting and that accounting account for numerical sequence of receiving reports on a regular basis.

18-23 (continued)

EXCEPTION	a. TYPE OF EXCEPTION	b. TRANSACTION-RELATED AUDIT OBJECTIVE NOT MET	c. AUDIT IMPORTANCE	d. FOLLOW-UP	e. EFFECT ON AUDIT	f. PREVENTIVE CONTROLS
7	Control deviation and Monetary misstatement	Recorded acquisitions are for goods and services received, consistent with the best interests of the client (occurrence). Recorded acquisition transactions are correctly stated (accuracy).	Absence of receiving reports prevents the auditor from determining whether or not the goods were received and processed on a timely basis. The extension error indicates that the clerical accuracy of invoice tests are ineffective.	Obtain bill of lading copy from vendor to determine whether or not the merchandise was received. Determine if the absence of receiver indicates that they are not compared to the invoice. Determine the exception rate by expanding the tests if the misstatement noted is considered significant.	If either of the problems is considered significant to the auditor, he or she should expand the scope of his or her tests of controls or substantive tests of transactions to determine the effect on the financial statements.	Require that copies of receiving reports must be present before invoices are approved for payment. Have an independent person test extensions to determine that the clerical tests are effective.

NOTE: For all monetary misstatements that are potential frauds, the auditor should evaluate whether a fraud occurred. Even one fraud is sufficient for the auditor to consider the potential impact on the audit, primarily because materiality is normally smaller for fraud than for errors.

18-24

MISSTATEMENT	a. TRANSACTION-RELATED AUDIT OBJECTIVE NOT MET	b. PREVENTIVE CONTROL	c. SUBSTANTIVE PROCEDURE
1	Cash disbursement transactions are recorded on the correct dates (timing).	Transactions are recorded automatically using a computer process with the same information as the check preparation.	Trace last checks written to cash disbursements journal. Examine date checks cancelled at bank to determine if checks were held by the client.
2	Acquisition transactions are recorded on the correct dates (timing).	Receiving reports to be delivered to accounting at the end of the day on which the raw materials are received. Accounting department accounts for numerical sequence of receiving reports after obtaining the last number used from receiving personnel.	At the date on which the cutoff test is to be performed, the auditor obtains the number of the last receiving report(s) that should have been recorded and accounts for the numerical sequence of all previous receiving report(s) that should have been recorded.
3	Recorded acquisitions are for goods and services received, consistent with the best interests of the client (occurrence).	Require that an authorized purchase order and/or approval of each invoice by the ordering department head be required before payments are made for goods received.	Examine underlying documents for reasonableness and authenticity.

18-24 (continued)

MISSTATEMENT	a. TRANSACTION-RELATED AUDIT OBJECTIVE NOT MET	b. PREVENTIVE CONTROL	c. SUBSTANTIVE PROCEDURE
4	Acquisition transactions are properly classified (classification).	Account distributions are reviewed by a responsible individual prior to entry into the system.	Examination of supporting invoices for entries into the repairs and maintenance account to verify the proper account distribution.
5	Recorded cash disbursements are for goods and services actually received (occurrence).	Once checks are signed by the treasurer, they are returned to someone independent of purchasing and accounts payable for mailing. All supporting documents are cancelled to prevent reuse.	Review physical inventory shortages for unusual or inconsistent occurrences. Compare payee on the check to the company name on the vendor's invoice.
6	Recorded cash disbursement transactions are correctly stated (accuracy).	Checks are prepared using a computer process, which assures simultaneous preparation of check and journal. Reconcile bank account on a timely basis at the end of each month.	Compare check amounts to entries in the cash disbursements journal. Test bank reconciliation.

18-25 a. The type of audit evidence used for each procedure is as follows:

AUDIT PROCEDURE	TYPE OF AUDIT EVIDENCE
1	Reperformance
2	Inspection of internal documentation; reperformance
3	Substantive analytical procedure
4	Inspection of external documentation (exchange rate); reperformance
5	Inquiries of client
6	Inspection of external documentation
7	Confirmation
8	Inspection of internal and external documentation
9	Substantive analytical procedure

b.

AUDIT PROCEDURE	BALANCE-RELATED AUDIT OBJECTIVE						
	Detail tie-in	*Existence*	*Completeness*	*Accuracy*	*Classification*	*Cutoff*	*Obligations*
1	X						
2					X		
3		X	X				
4				X			
5					X		
6		X	X	X		X	
7		X	X	X		X	
8			X			X	
9		X	X			X	

Note: Rights and Realizable value are not applicable to accounts payable.

18-25 (continued)

c. Auditing standards require that all audit objectives be met by gathering sufficient appropriate evidence. Auditor judgment is required to determine the appropriate evidence to satisfy each objective. For example, where an objective is contributed to by an audit procedure that uses less reliable evidence, the audit objective will not be completely met. In such a case, additional evidence will be gathered using other audit procedures.

   In this case, the evidence used in procedure 5 is from inquiries of the client, which is generally a weak form of evidence. Thus, the classification objective could require more reliable evidence from other audit procedures to be fully met.

   Procedure 2 uses internal documentation as its primary evidence. The reliability of this procedure would depend on the effectiveness of the client's internal controls in producing the internal documents.

18-26

a. Vouchers 2528 and 2531 were incorrectly included in the June 2016 acquisitions journal. The associated goods were received after June 30, 2016.

   As for July 2016, voucher numbers 2527 and 2530 were incorrectly included because the goods were actually received before the end of June 2016.

   Let's assume the corrections were made in two journal entries as follows:

Accounts payable	$11,687.99	
Inventory		$11,687.99
Inventory	$ 6,935.73	
Accounts payable		$ 6,935.73

b. Improper dating of receiving reports 7280 through 7282 would result in the improper recording of vouchers 2528, 2529, and 2531 in the June 2016 acquisitions journal. That would result in the overstatement of inventory and accounts payable as of June 30, 2016, by $16,576.32. The auditor might catch this by comparing receiving reports recorded just before year end to vendor invoices or vendor statements to determine if the items reflected as being received by the client just prior to year end are included in the vendor invoice or vendor statement as a balance owed as of June 30.

c. To verify the appropriateness of the cutoff of inventory acquisitions and the related accounts payable balance at year end, the auditor examines receipts of goods before and after the balance sheet date to ensure those items received before year end are included in the acquisitions journal (and thus the accounts payable balance) in the last month of the fiscal year. The auditor also determines that receipts of goods after year end are not reflected in the acquisitions journal (and thus the accounts payable balance) as of year end.

d. Possible internal controls that would prevent the errors noted at the Broughton Cap Company include the following:

- Require that receiving reports be completed in sequential order as goods are received.
- Require receiving reports to be routed to accounts payable daily for immediate voucher preparation.
- Accounts payable clerks account for the numerical sequence of receiving reports and prepare voucher packages in numerical sequence starting based on the order of receiving reports received.
- An independent person matches the purchase order, receiving report, and voucher package and verifies accuracy and correctness of dates of receipts relative to dates of recording of voucher in the acquisitions journal.
- Vendor statements are reconciled on a monthly basis with the accounts payable master file.

18-27 a. The fact that the client made a journal entry to record vendors' invoices which were received late should simplify the CPA's test for unrecorded liabilities and reduce the possibility of a need for a further adjustment, but the CPA's test is nevertheless required. Clients normally are expected to make necessary adjustments to their books so that the CPA may audit financial statements that the client believes are complete and correct. If the client has not recorded late invoices, the CPA is compelled in his or her testing to substantiate what will ultimately be recorded as an adjusting entry. In this audit, the CPA should test entries in the 2017 voucher register to ascertain that all items that were applicable to 2016 have been included in the journal entry recorded by the client.

b. Whenever a CPA is justified in relying on work done by an internal auditor he or she can reduce (but not eliminate) his or her own audit work. In this case, the CPA should have determined early in his or her audit that Ozine's internal auditor is qualified by being both technically competent and reasonably independent. Once satisfied as to these points, the CPA should discuss the nature and scope of the internal audit program with the internal auditor and review his or her internal audit schedules in order that the CPA may properly coordinate his or her own program with that of the internal auditor. If the Ozine internal auditor is qualified and has made tests for unrecorded liabilities, the CPA may limit his or her work to a less extensive test in this audit area if the results of the internal auditor’s tests were satisfactory.

c. No. Response to inquiry alone generally does not constitute sufficient appropriate evidence. The CPA should obtain a letter in which responsible executives of the client’s organization represent that to the best of their knowledge all liabilities have been recognized. However, this is done as a normal audit procedure to remind the client of his or her responsibilities and the statements that have been made. It does not relieve the CPA of the responsibility for making his or her own tests.

d. Work done by an auditor for a federal agency will normally have no effect on the scope of the CPA’s audit, since the concern of government auditors is usually limited to matters which are unrelated to the financial statements. Nevertheless, the CPA should discuss the government auditor’s work program with him or her, as there are isolated situations where specific procedures followed to a satisfactory conclusion by a government auditor will furnish the CPA with added assurance and therefore permit him or her to reduce certain work in an area. However, government auditors are usually interested primarily in substantiating as valid and allowable those costs which a company has allocated against specific government contracts or sales to the government, and consequently there is little likelihood that the auditor for a federal agency at Ozine would check for unrecorded liabilities.

(Another reason for discussing the federal auditor’s results with him or her is that his or her findings may affect the financial statements in other ways.)

e. In addition to the 2017 acquisitions journal, the CPA should consider the following sources for possible unrecorded liabilities:

1. If a separate cash disbursements journal exists, examine underlying documentation for disbursements recorded during the first part of 2017. Determine if any of the disbursements relate to acquisitions that should have been recorded in 2016.

18-27 (continued)

2. Vendors' invoices that have not been entered in the acquisitions journal.
3. Status of tax returns for prior years still open.
4. Discussions with employees.
5. Representations from management.
6. Comparison of account balances with preceding year.
7. Examination of individual accounts during the audit.
8. Existing contracts and agreements.
9. Minutes.
10. Attorneys' bills and letters of representation.
11. Status of renegotiable business.
12. Correspondence with principal suppliers.
13. Audit testing of cutoff date for reciprocal accounts, e.g., inventory and fixed assets.

18-28

a. BERGERON INTERNAL CONTROLS	b. TRANSACTION-RELATED AUDIT OBJECTIVE(S)	c. TEST OF CONTROLS
1. Prenumbered purchase orders are used and accounted for.	Occurrence, Completeness	Review Bergeron's accounting for the sequence of purchase orders to determine if all are properly accounted for.
2. All purchase orders must be approved by the vice president of finance.	Occurrence	Examine a sample of purchase orders and verify that all are properly approved by the vice president of finance.
3. Prenumbered receiving reports are prepared upon receipt of goods.	Completeness	Review Bergeron's accounting for the sequence of receiving reports to determine if all are properly accounted for.
4. Goods are stored in a warehouse that is under the control of the shipping manager.	Completeness	Observe whether access to the inventory in the warehouse is properly restricted. Inquire as to how the shipping manager restricts access to inventory.

18-28 (continued)

a. BERGERON INTERNAL CONTROLS	b. TRANSACTION-RELATED AUDIT OBJECTIVE(S)	c. TEST OF CONTROLS
5. Perpetual inventory records are updated upon receipt of goods as evidenced by the receiving report.	Completeness, Accuracy, Timing	Examine a sample of receiving reports and verify that the perpetual inventory records were updated on a timely basis.
6. Chief accountant matches vendor invoices to purchase order and receiving reports (If related to goods purchased), checking for accuracy and appropriateness. Chief accountant documents review by initialing documents.	Occurrence, Completeness, Accuracy	Examine a sample of matched documents and verify that all are properly initialed by the chief accountant and that amounts are accurate and appropriate.
7. Access to accounting records is restricted by password to the chief accountant.	Occurrence	Attempt to access the accounting records with an invalid password.
8. Accounting records are updated timely based on matching of documentation.	Timing	Examine a sample of matched documents and verify that entries were made in the accounting records in the correct time period.
9. President reviews all documentation before approving cash disbursements and controls signed checks until mailing.	Occurrence	Examine a sample of cash disbursement transactions and verify that all are properly approved by the president.
10. Controller performs a monthly bank reconciliation.	Occurrence, Completeness, Accuracy, Timing	Examine a sample of monthly bank reconciliations to verify they were performed and properly completed.

18-28 (continued)

a. BERGERON INTERNAL CONTROLS	b. TRANSACTION-RELATED AUDIT OBJECTIVE(S)	c. TEST OF CONTROLS
11. Controller reconciles on a monthly basis the accounts payable listing to the accounts payable general ledger account. Controller initials reconciliation upon completion.	Posting and summarization	Examine a sample of monthly reconciliations to determine they are initialed and prepared properly.
12. Independent inventory counts are obtained quarterly and reconciled to the perpetual inventory records.	Occurrence, Completeness, Accuracy	Observe client inventory count teams during one of the quarterly inventory counts to determine whether they are following the client's inventory counting procedures.

18-29 a. It is an appropriate procedure to have the client perform the reconciliations of vendors' statements as long as the auditor maintains control over the statements received directly from the vendor and the auditor performs adequate tests to determine that the reconciling items shown on the reconciliations are proper.

b. On Statement 1, the auditor must determine that the payment was recorded on the company's books prior to June 30. The auditor may also want to examine the cutoff bank statement to determine if the check to this vendor cleared the bank within a reasonable amount of time.

For Statement 2, the auditor should request that the vendor provide additional details of the account balance. Otherwise, the auditor will not be able to use the vendor's statement and will have to include the $5,735.69 as a potential misstatement.

For Statement 3, the auditor must determine whether or not the item for which the credit memo was issued by the vendor on July 15 was appropriately recorded on the company's records at June 30, including consideration of inventory.

The Statement 4 reconciliation is incorrect. The payment by Milner on July 3 should not have been deducted from the accounts payable balance per the master file. The auditor should investigate the unlocated difference, since it could be comprised of two much larger offsetting amounts that the auditor may wish to test.

18-29 (continued)

On Statement 5, the auditor must determine that the payment was recorded on the company's records prior to June 30 and investigate the reason that the vendor had not received the payment at the time his or her statement was prepared. The auditor must determine whether or not the goods represented on the invoices that Milner had not received were in the company's inventory at June 30. This may be accomplished by requesting that the vendor send proof of shipment for the goods invoiced.

c. The auditor must consider whether the coverage achieved by the 18 confirmations that were received directly from the vendors is sufficient outside verification of the accounts payable balance at June 30. If the auditor is satisfied with this coverage, he or she may wish to support the four nonresponses by examining vendor invoices in support of the amount recorded in the master file. If the client has received vendor statements from any of these four suppliers, the auditor may wish to reconcile these statements.

■ Case – Ward Publishing Company

18-30 Part I (see text Web site for Excel solution - Filename **P1830.xls**)

Application of audit sampling is not appropriate for Procedures 1 through 8 due to the nature of the procedures. In this case, audit sampling is also not appropriate for Procedure 10 because the sampling unit is a line item in the cash disbursements journal. The sampling data sheet that follows represents an attributes sampling approach. The only differences between this approach and a nonstatistical sampling approach are the estimate of ARO and the determination of sample sizes. See the footnotes to the sampling data sheet for further explanations. A sampling data sheet using attributes sampling follows:

		PLANNED AUDIT			
	DESCRIPTION OF ATTRIBUTE	**EPER**	**TER**	**ARO***	**INITIAL SAMPLE SIZE****
9.a.	Entry in CD journal agrees with details on cancelled check.	0%	6%	10%	38
9.b.(1)	All supporting documents attached to vendor's invoice.	1%	5%	10%	77
9.b.(2)	Documents agree with disbursements.	0%	6%	10%	38

18-30 (continued)

	DESCRIPTION OF ATTRIBUTE	PLANNED AUDIT			
		EPER	TER	ARO*	INITIAL SAMPLE SIZE**
9.b.(3)	Entry in CD journal agrees with details on vendor's invoice.	0%	6%	10%	38
9.b.(4)	Discount was taken as appropriate.	0%	6%	10%	38
9.b.(5)	Vendor's invoice initialed.	1%	5%	10%	77
9.b.(6)	Account coding reasonable.	0%	6%	10%	38
9.b.(7)	Purchases approved by Ward.	1%	5%	10%	77
9.b.(8)	P.O. or P.R. properly approved.	1%	5%	10%	77
9.b.(9)	Prices, footings, and extensions are correct.	0%	6%	10%	38
9.b.(10)	Details on supporting documents agree.	0%	6%	10%	38
9.b.(11)	Documents properly completed and cancelled upon payment.	1%	5%	10%	77

* For a nonstatistical sampling data sheet, ARO columns should indicate "medium" for all attributes.

** For a nonstatistical sampling data sheet, students' determination of sample size will vary. While no one answer is correct, the sample size chosen for each attribute should reflect the EPER, TER, and ARO for that attribute.

18-30 (continued)

Part II

a. *Attributes sampling approach*: The results portion of the sampling data sheet are as follows:

ATTRIBUTE NO.	SAMPLE SIZE	EXCEPTIONS	SAMPLE EXCEPTION RATE	CUER
9.a.	50	0	0	4.6%
9.b. (1)	50	1*	2%	7.6%
(2)	50	0	0	4.6%
(3)	50	0	0	4.6%
(4)	50	0	0	4.6%
(5)	50	6*	12%	20.2%
(6)	50	3**	6%	12.9%
(7)	50	0	0	4.6%
(8)	50	0	0	4.6%
(9)	50	0	0	4.6%
(10)	50	0	0	4.6%
(11)	50	0	0	4.6%

* Control deviations
** Monetary misstatements

Nonstatistical approach: Because CUER under nonstatistical sampling is estimated using auditor judgment, students' answers to this question will vary. They will most likely be similar to the CUERs calculated using attributes sampling.

Because the SER is zero for attributes 9.a., 9.b.(2) through (4), and 9.b.(7) through (11), it is unlikely that students will estimate CUER greater than the TER of 5% (tests of controls) or 6% (substantive tests of transactions). For attribute 9.b.(5) students should conclude that the results are not acceptable because the SER of 12% clearly exceeds the TER of 5%. For attribute 9.b.(6), even though the SER equals the TER of 6%, the results are not acceptable because sampling risk must be considered in determining CUER. For attribute 9.b.(1), students' estimates of CUER will be more variable since the SER is only 2%. Some students will find the results acceptable, and some will not, depending on their estimates of sampling risk.

18-30 Part II (continued)

b. Exception 1 is not an exception, and has no effect on tests of details of accounts payable.

Exception 2 is a control deviation. Even though it is not a monetary misstatement, controls require the presence of all supporting documents before a purchase and the related disbursement are processed. If an invalid purchase is recorded, the liability and the related debited account may be overstated. If an invalid disbursement is recorded, accounts payable may be inappropriately reduced. Thus, misstatements in the occurrence of those transactions could actually result in both overstatements and understatements of accounts payable. Tests for occurrence include tracing items on the accounts payable listing to supporting documents and confirmation of accounts payable and reconciliation to vendors' statements.

Exception 3 is a control deviation where one-half of those items also contain monetary misstatements. Misclassification is a serious misstatement. However, it relates to the debit entry, not the credit to accounts payable. Tests supporting charges to assets and expense accounts will need to be increased, but tests of accounts payable will probably not be affected.

c. An audit program for accounts payable is shown on the following page. The balance-related audit objectives tested by each procedure are indicated. Because the appropriate acceptable audit risk for accounts payable is high and inherent risk is low, and because substantive analytical review procedures were excellent, detailed tests should be held to a minimum. The exception to this is for procedure 3; this has not been reduced because of the exception in procedure 9.b.(1).

18-30 Part II (continued)

	BALANCE-RELATED AUDIT OBJECTIVES						
	Detail tie-in	*Existence*	*Completeness*	*Accuracy*	*Classification*	*Cutoff*	*Obligations*
1. Obtain list of accounts payable. Foot the list and agree to general ledger.	X						
2. Trace all items on the list over $10,000 to vendor's invoice and supporting documents.		X		X			
3. Obtain vendor's statements for 20 vendors with greatest volume of purchases, plus 10 others, by confirmation. Reconcile statements to accounts payable list.		X	X	X		X	
4. Examine all subsequent period disbursements and payments in process of amounts over $5,000 to determine if they were recorded in the proper period.			X			X	
5. Review the list of accounts payable for proper classification of accounts due to related parties, debit balances, or items with unusual terms.					X		

Note: Rights and Realizable value are not applicable to accounts payable. No audit work was considered necessary for obligations.