


## AUDITING EARTHWEAR'S PURCHASING PROCESS

 EarthWear's purchasing process is "the other side of the coin" from the revenue process. In order to support its revenue process, EarthWear must have merchandise to sell. As is the case with most of its competitors, EarthWear purchases almost all of its merchandise for resale. It has a large number of suppliers and a large number of transactions in this process. Willis & Adams needs to gain assurance that the information in EarthWear's financial statements correctly represents the economic reality of its purchases and cash disbursements transactions with its many suppliers.

Willis & Adams will collect audit evidence to confirm or refute the explicit and implicit management assertions about those transactions, such as occurrence, completeness, and so on. Because EarthWear has hundreds of thousands of transactions in a year, in obtaining this assurance they will rely heavily on EarthWear's controls over the purchasing

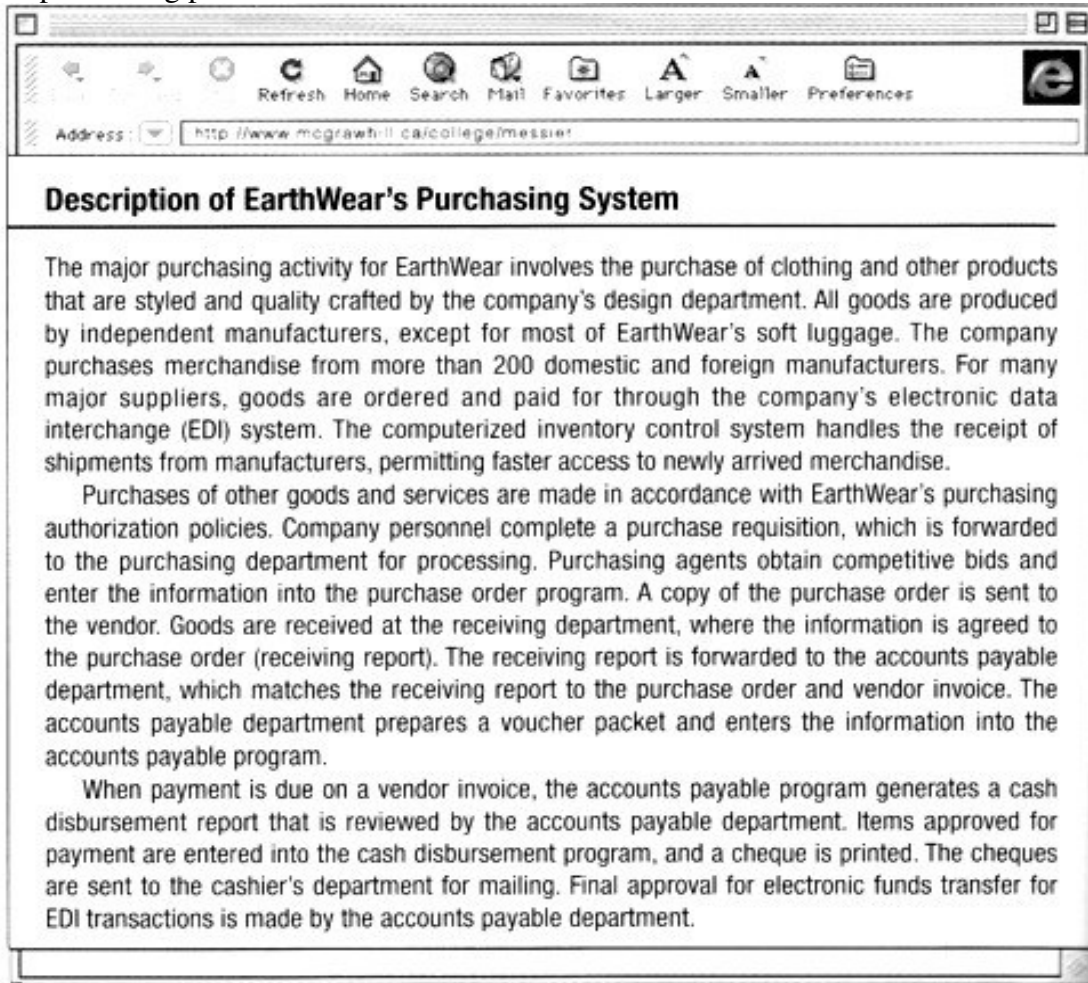
process. Therefore they will spend a significant amount of audit effort understanding and testing those controls. The results of the tests of controls will affect the nature, timing, and extent of subsequent audit procedures.

Willis and Adams will also collect audit evidence to support or refute the explicit and implicit management assertions, such as existence, and rights and obligations, about the accounts and balances affected by those transactions. The primary account affected is accounts payable and as well as understanding and testing EarthWear's controls related to accounts payable, Willis & Adams will also employ substantive tests in testing this account. Because purchases is an expense (i.e., it becomes the cost of goods sold) and accounts payable is a liability, the auditors' concern is normally with possible understatement rather than with overstatement as was the case with revenues and accounts receivable.

An entity's expense recognition policies and the type of expenses involved affect how the transactions are recorded and accounted for in the financial statements. Expenses can be classified into three categories.

1. Certain expenses can be matched directly with specific transactions or events and are recognized upon recognition of revenue. These types of expenses are referred to as *product costs* and include expenses such as cost of goods sold.
2. Many expenses are recognized during the period in which cash is spent or liabilities incurred for goods and services that are used up at that time or shortly thereafter. Such expenses cannot be directly related to specific transactions and are assumed to provide no future benefit. These expenses are referred to as *period costs*. Examples of such expenses include administrative salaries and rent expense.
3. Some expenses are allocated by systematic and rational procedures to the periods during which the related assets are expected to provide benefits. Amortization of plant and equipment is an example of such an expense.

## overview of purchasing process



You should focus on the basic concepts to apply them to the specific purchasing processes encountered. The following topics related to the purchasing process are covered:

- types of transactions and financial statement accounts affected
- types of documents and records
- major functions
- segregation of duties

Three types of transactions are processed through the purchasing process:

- purchase of goods and services for cash or credit
- payment of the liabilities arising from such purchases
- return of goods to suppliers for cash or credit

**Table 9-1      Functions of the Purchasing Process**

• <i>Requisitioning</i>	Initiation and approval of requests for goods and services by authorized individuals consistent with management criteria.
• <i>Purchasing</i>	Approval of purchase orders and proper execution as to price, quantity, quality, and vendor.
• <i>Receiving</i>	Receipt of properly authorized goods or services.
• <i>Invoice processing</i>	Processing of vendor invoices for goods and services received; also, processing of adjustments for allowances, discounts, and returns.
• <i>Disbursements</i>	Processing of payment to vendors.
• <i>Accounts payable</i>	Recording of all vendor invoices, cash disbursements, and adjustments in individual vendor accounts.
• <i>General ledger</i>	Proper accumulation, classification, and summarization of purchases, cash disbursements, and payables in the general ledger.

**Table 9-2      Documents and Records Involved in the Purchasing Process**

- Purchase requisition.
- Purchase order.
- Receiving report.
- Vendor invoice.
- Voucher.
- Voucher register/purchases journal.
- Accounts payable subsidiary ledger.
- Vendor statement.
- Cheque.
- Cash disbursements journal/cheque register.

**Table 9-3 Key Segregation of Duties in the Purchasing Process and Possible Errors or Fraud**

<i>Segregation of Duties</i>	<i>Possible Errors or Fraud Resulting from Conflicts of Duties</i>
The purchasing function should be segregated from the requisitioning and receiving functions.	If one individual is responsible for the requisition, purchasing, and receiving functions, fictitious or unauthorized purchases can be made. This can result in the theft of goods and possibly payment for unauthorized purchases.
The invoice-processing function should be segregated from the accounts payable function.	If one individual is responsible for the invoice-processing and the accounts payable functions, purchase transactions can be processed at the wrong price or terms, or a cash disbursement can be processed for goods or services not received. This can result in overpayment for goods and services or the theft of cash.
The disbursement function should be segregated from the accounts payable function.	If one individual is responsible for the disbursement function and also has access to the accounts payable records, unauthorized cheques supported by fictitious documents can be issued, and unauthorized transactions can be recorded. This can result in theft of the entity's cash.
The accounts payable function should be segregated from the general ledger function.	If one individual is responsible for the accounts payable records and also for the general ledger, that individual can conceal any defalcation that would normally be detected by reconciling subsidiary records with the general ledger control account.

**Table 9-4 Segregation of Duties for Purchasing and Accounts Payable Functions by Department**

<i>Purchasing and Accounts Payable Function</i>	<b>Department</b>				
	<i>Purchasing</i>	<i>Receiving</i>	<i>Accounts Payable</i>	<i>Cashier's</i>	<i>IT</i>
Preparation and approval of purchase order	X				
Receipt, counting, and inspection of purchased materials		X			
Receipt of vendor invoices and matching them with supporting documents			X		
Coding (or checking) of account distributions			X		
Updating of accounts payable records			X		X
Preparation of vendor cheques					X
Signing and mailing of vendor cheques				X	
Preparation of voucher register					X
Reconciliation of voucher register to general ledger			X		

Table 9-7

## Summary of Assertions, Possible Misstatements, Control Procedures, and Tests of Controls for Cash Disbursement Transactions

<i>Assertion</i>	<i>Possible Misstatement</i>	<i>Control Procedure</i>	<i>Test of Controls</i>	
Occurrence	Cash disbursement recorded but not made	Segregation of duties	Observe and evaluate proper segregation of duties.	
		Vendor statements independently reviewed and reconciled to accounts payable records	Review client's procedures for reconciling vendor statements.	
		Monthly bank reconciliations prepared and reviewed	Review monthly bank reconciliations for indication of independent review.	
Completeness	Cash disbursement made but not recorded	Same as above	Same as above	
		Accounting for the numerical sequence of cheques	Review and test client's procedures for numerical sequence of cheques; if IT application, test application controls.	
		Daily cash disbursements reconciled to postings to accounts payable subsidiary records	Review procedures for reconciling daily cash disbursements with postings to accounts payable subsidiary records; if IT application, test application controls.	
Accuracy	Cash disbursement recorded at incorrect amount	Daily cash disbursements report reconciled to cheques issued	Review reconciliation.	
		Vendor statements reconciled to accounts payable records and independently reviewed	Review reconciliation.	
		Monthly bank statements reconciled and independently reviewed	Review monthly bank reconciliations.	
	Cash disbursement posted to the wrong vendor account	Vendor statements reconciled and independently reviewed	Review reconciliation.	
		Cash disbursements journal not summarized properly or not properly posted to general ledger accounts	Monthly cash disbursements journal agreed to general ledger postings	Review postings from cash disbursements journal to the general ledger.
			Accounts payable subsidiary records reconciled to general ledger control account	Review reconciliation.
Cutoff	Cash disbursement recorded in wrong period	Daily reconciliation of cheques issued with postings to the cash disbursements journal and accounts payable subsidiary records	Review daily reconciliations.	
Classification	Cash disbursement charged to wrong account	Chart of accounts	Review cash disbursements journal for reasonableness of account distribution.	
		Independent approval and review of general ledger account on voucher packet	Review general ledger account code on voucher packet for reasonableness.	

exercises

- 9-16 When goods are received, the receiving clerk should match the goods with
- The purchase order and the requisition form.
  - The vendor invoice and the receiving report.
  - The vendor shipping document and the purchase order.
  - The receiving report and the vendor shipping document.
- 9-17 In a properly designed accounts payable system, a voucher is prepared after the invoice, purchase order, requisition, and receiving report are verified. The next step in the system is
- Cancellation of the supporting documents.
  - Entry of the cheque amount in the cheque register.
  - Entering of the voucher into the voucher register.
  - Approval of the voucher for payment.
- 9-18 An internal control questionnaire indicates that an approved receiving report is required to accompany every cheque request for payment of merchandise. Which of the following procedures provides the greatest assurance that this control is operating effectively?
- Selection and examination of cancelled cheques and ascertainment that the related receiving reports are dated *no later than* the cheques.
  - Selection and examination of cancelled cheques and ascertainment that the related receiving reports are dated *no earlier than* the cheques.
  - Selection and examination of receiving reports and ascertainment that the related cancelled cheques are dated *no earlier than* the receiving reports.
  - Selection and examination of receiving reports and ascertainment that the related cancelled cheques are dated *no later than* the receiving reports.
- 9-19 Internal control is strengthened when the quantity of merchandise ordered is omitted from the copy of the purchase order sent to the
- Department that initiated the requisition.
  - Receiving department.
  - Purchasing agent.
  - Accounts payable department.



- 9-20** Which of the following internal control procedures is *not* usually performed in the accounts payable department?
- Matching the vendor's invoice with the related receiving report.
  - Approving vouchers for payment by having an authorized employee sign the vouchers.
  - Indicating the asset and expense accounts to be debited.
  - Accounting for unused prenumbered purchase orders and receiving reports.
- 9-21** Which of the following is the most effective control procedure to detect vouchers prepared for the payment of goods that were *not* received?
- Counting of goods upon receipt in storeroom.
  - Matching of purchase order, receiving report, and vendor invoice for each voucher in the accounts payable department.
  - Comparison of goods received with goods requisitioned in receiving department.
  - Verification of vouchers for accuracy and approval in internal audit department.
- 9-22** In a properly designed purchasing process, the same employee most likely would match vendors' invoices with receiving reports and also
- Post the detailed accounts payable records.
  - Recompute the calculations on vendors' invoices.
  - Reconcile the accounts payroll ledger.
  - Cancel vendors' invoices after payment.
- 9-23** For effective internal control purposes, which of the following individuals should be responsible for mailing signed cheques?
- Receptionist.
  - Treasurer.
  - Accounts payable clerk.
  - Payroll clerk.
- 9-24** Budd, the purchasing agent of Lake Hardware Wholesalers, has a relative who owns a retail hardware store. Budd arranged for hardware to be delivered by manufacturers to the retail store on a C.O.D. basis, thereby enabling his relative to buy at Lake's wholesale prices. Budd was probably able to accomplish this because of Lake's poor internal control over
- Purchase requisitions.
  - Cash receipts.
  - Perpetual inventory records.
  - Purchase orders.
- 9-25** To determine whether accounts payable are complete, an auditor performs a test to verify that all merchandise received is recorded. The population of documents for this test consists of all
- Vendor invoices
  - Purchase orders.



- c. Receiving reports.
- d. Cancelled cheques.

Which of the following controls would most effectively ensure that recorded purchases are free of material errors?

- a. The receiving department compares the quantity ordered on purchase orders with the quantity received on receiving reports.
- b. Vendor invoices are compared with purchase orders by an employee who is independent of the receiving department.
- c. Receiving reports require the signature of the individual who authorized the purchase.
- d. Purchase orders, receiving reports, and vendor invoices are independently matched in preparing vouchers.

Which of the following procedures is *least* likely to be performed before the balance sheet date?

- a. Test of internal control over cash.
- b. Confirmation of receivables.
- c. Search for unrecorded liabilities.
- d. Observation of inventory.

When using confirmations to provide evidence about the completeness assertion for accounts payable, the appropriate population most likely would be

- a. Vendors with whom the entity has previously done business.
- b. Amounts recorded in the accounts payable subsidiary ledger.
- c. Payees of cheques drawn in the month after year-end.
- d. Invoices filed in the entity's open invoice file.

Purchase cutoff procedures should be designed to test whether all inventory

- a. Purchased and received before the end of the year was paid for.
- b. Ordered before the end of the year was received.
- c. Purchased and received before the end of the year was recorded.
- d. Owned by the company is in the possession of the company at the end of the year.

Which of the following audit procedures is best for identifying unrecorded trade accounts payable?

- a. Examination of unusual relationships between monthly accounts payable balances and recorded cash payments.
- b. Reconciliation of vendors' statements to the file of receiving reports to identify items received just prior to the balance sheet date.
- c. Investigation of payables recorded just prior to and just subsequent to the balance sheet date to determine whether they are supported by receiving reports.
- d. Review of cash disbursements recorded subsequent to the balance sheet date to determine whether the related payables apply to the prior period.