Chapter 18

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

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

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

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

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

5 Design and perform analytical procedures for accounts payable.

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

7 Distinguish the reliability of vendors’ invoices, vendors’ statements, and conformations of accounts payable as audit evidence.
Identify the accounts and the classes of transactions in the acquisition and payment cycle.
Transactions in the Acquisition and Payment Cycle

Three classes of transactions:
1. Acquisitions of goods and services
2. Cash disbursements
3. Purchase returns and allowances and purchase discounts
Accounts in the Acquisition and Payment Cycle

FIGURE 18-1 Accounts in the Acquisition and Payment Cycle

- **Cash in bank**
  - Purchase returns and allowances
  - Purchase discounts

- **Accounts payable**
  - Cash disbursements
  - Acquisitions of goods and services

- **Raw material purchases**
  - Property, plant, and equipment
  - Prepaid expenses

- **Manufacturing expense control account**
  - Subsidiary accounts
  - Repair and maintenance
  - Taxes
  - Supplies
  - Freight in
  - Utilities

- **Selling expense control account**
  - Subsidiary accounts
  - Commissions
  - Travel expense
  - Delivery expense
  - Repairs
  - Advertising

- **Administrative expense control account**
  - Subsidiary accounts
  - Supplies
  - Officers' travel
  - Legal fees
  - Auditing fees
  - Taxes
Describe the business functions and the related documents and records in the acquisition and payment cycle.
Classes of Transactions and Accounts

Acquisitions:

- Inventory
- Property, plant, and equipment
- Prepaid expenses
- Leasehold improvements
- Accounts payable
- Manufacturing expenses
- Selling and administrative expenses
Classes of Transactions and Accounts

Cash disbursements:

- Cash in bank (from cash disbursements)
- Accounts payable
- Purchase discounts
Business Functions in the Cycle

- Processing Purchase Orders
- Receiving Goods and Services
- Recognizing the Liability
- Processing & Recording cash disbursements
Related Documents and Reports

Processing purchase orders:
- Purchase requisition
- Purchase order

Receiving goods and services:
- Receiving report
Related Documents and Reports

Recognizing the liability:

- Vendor’s invoice
- Debit memo
- Voucher
- Acquisitions transaction file
Recognizing the liability:

- Acquisitions journal or listing
- Accounts payable master file
- Accounts payable trial balance
- Vendor statement
Related Documents and Reports

Processing and recording cash disbursements:
- Check
- Cash disbursements transaction file
- Cash disbursements journal or listing
Understand internal control, and design and perform tests of controls and substantive tests of transactions for the acquisition and payment cycle.
Methodology for Designing Controls and Substantive Tests

1. Understand internal control—acquisitions and cash disbursements
2. Assess planned control risk—acquisitions and cash disbursements
3. Determine extent of testing controls*
4. Design tests of controls and substantive tests of transactions for acquisitions and cash disbursements to meet transaction-related audit objectives

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

- Study the client’s flowcharts
- Review internal control questionnaires
- Perform walk-through tests
Assess Planned Control Risk

- Authorization of purchases
- Separation of asset custody from other functions
- Timely recording and independent review of transactions
- Authorization of payments
Determine Extent of Testing of Controls

- The auditor identifies the key internal controls and weaknesses and assesses control risk.
- The auditor performs tests of controls to obtain evidence that controls are operating effectively.
Controls and Substantive Tests of Transactions for Acquisitions

- Recorded acquisitions are for goods and services received (occurrence)
- Existing acquisitions are recorded (completeness)
- Acquisitions are accurately recorded (accuracy)
Controls and Substantive Tests of Transactions for Acquisitions

- Acquisitions are correctly included in the master files (posting and summarization)
- Acquisitions are correctly classified (classification)
- Acquisitions are recorded on the correct dates (timing)
Attributes Sampling

Because of the importance of tests of controls and substantive tests of transactions for acquisitions and cash disbursements, the use of attributes sampling is common in this audit area.
Important Differences Compared to other Cycles

Acquisitions and Payments Cycle transactions:
- Larger number of transactions
- Significant judgment
- Wide range of dollar amount
Describe the methodology for designing tests of details of balances for accounts payable using the audit risk model.
Methodology for Designing Tests of Balances for Accounts Payable

<table>
<thead>
<tr>
<th>Identify client business risks affecting accounts payable</th>
<th>Phase I</th>
</tr>
</thead>
<tbody>
<tr>
<td>Set performance materiality and assess inherent risk for accounts payable</td>
<td>Phase I</td>
</tr>
<tr>
<td>Assess control risk for the acquisition and payment cycle</td>
<td>Phase I</td>
</tr>
</tbody>
</table>
Methodology for Designing Tests of Balances for Accounts Payable

Design and perform tests of controls and substantive tests of transactions for the acquisition and payment cycle

Phase II
Methodology for Designing Tests of Balances for Accounts Payable

<table>
<thead>
<tr>
<th>Design and perform analytical procedures for accounts payable balance</th>
<th>Audit procedures</th>
<th>Sample size</th>
<th>Items to select</th>
<th>Timing</th>
<th>Phase III</th>
</tr>
</thead>
<tbody>
<tr>
<td>Design tests of details of accounts payable balance to satisfy balance-related audit objectives</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Phase III</td>
</tr>
</tbody>
</table>

Phase III
Design and perform analytical procedures for accounts payable.
Analytical Procedures for the Acquisition and Payment Cycle

Analytical procedure

- Compare acquisition-related expense account balances with prior years
- Review list of accounts payable for unusual, nonvendor, and interest-bearing payables

Possible misstatement

- Misstatement of accounts payable and expenses
- Classification misstatement for nontrade liabilities
Analytical Procedures for the Acquisition and Payment Cycle

**Analytical procedure**

- Compare individual accounts payable with previous years
- Calculate ratios, such as purchases divided by accounts payable, and accounts payable divided by current liabilities

**Possible misstatement**

- Unrecorded or nonexistent accounts, or misstatements
- Unrecorded or nonexistent accounts, or misstatements
Design and perform tests of details of balances for accounts payable, including out-of-period liability tests.
Out-of-Period Liability Tests

- Examine underlying documentation for subsequent cash disbursements.
- Examine underlying documentation for bills not paid several weeks after the year-end.
- Trace receiving reports issued before year-end to related vendors’ invoices.
Out-of-Period Liability Tests

- Trace vendors’ statements that show a balance due to the accounts payable trial balance
- Send confirmations to vendors with whom the client does business
Cutoff Tests

- Relationship of cutoff to physical observation of inventory
- Inventory in transit
  - FOB destination
  - FOB origin
Distinguish the reliability of vendors’ invoices, vendors’ statements, and confirmations of accounts payable as audit evidence.
Reliability of Evidence

- Distinction between vendors’ invoices and vendors’ statements
- Difference between vendors’ statements and confirmations
Accounts Payable Confirmation

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

January 15, 2014

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

To Whom It May Concern:

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

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

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

Yours truly,

*Phil Geriovini*

Phil Geriovini, President
Sample sizes for accounts payable tests vary considerably, depending on many factors.

Statistical sampling is less commonly used for the audit of accounts payable than for accounts receivable.
Types of Audit Tests for the Acquisition and Payment Cycle

Cash in Bank

<table>
<thead>
<tr>
<th>Payments</th>
<th>Accounts Payable</th>
<th>Acquisition Expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Audited by TOC, STOT, and AP</td>
<td>Audited by TOC, STOT, and AP</td>
<td></td>
</tr>
</tbody>
</table>

Ending balance

TOC + STOT + AP + TDB

= Sufficient appropriate evidence
Types of Audit Tests for the Acquisition and Payment Cycle

Accounts Payable

Acquisition of assets
Audited by TOC, STOT, and AP

Ending balance
Audited by AP and TDB

TOC + STOT + AP + TDB = Sufficient appropriate evidence
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