Chapter 13: The Expenditure Cycle
Introduction

- Because this cycle involves the outflow of cash, it is the counterpoint to the revenue cycle.
- Expenditure cycles tend to be similar for all types of firms - merchandising to manufacturing to services.
- Two subsystems include:
  - The purchases processing system
  - The cash disbursements processing system
Objectives of the Cycle

- To ensure that all goods and services are ordered as needed
- To receive all ordered goods and verify that they are in good condition
- To safeguard goods until needed
- To ensure that invoices pertaining to goods and services are valid and correct
- To record and classify the expenditures promptly and accurately
- To post obligations and cash disbursements to proper suppliers’ accounts in the accounts payable ledger
- To ensure that all cash disbursements are related to authorized expenditures
- To record and classify cash disbursements promptly and accurately
Figure 13-1

Relationships of Organizational Units to Expenditure Cycle Functions

VP Logistics
- Purchasing
- Receiving
- Inventory
- Production
- Budgeting & Cash Planning
- Inventory Control
- Accounts Payable

VP Finance
- Cash Disbursements
- General Ledger
- Determine validity of payment obligation
- Make Cash Disbursements
- Post Transactions & Prepare Financial Reports

Recognize need for goods & services
- Place Order
- Receive and Store goods
- Maintain Accounts Payable
Documents Pertaining to the Expenditure Cycle

- Purchase Requisition
- Purchase Order
- Receiving Report
- Supplier’s (Vendor’s) Invoice
- Disbursement Voucher
- Disbursement Check
- Debit Memorandum
- New Supplier Form
- Request for Proposal

Figure 13-2
Purchasing & Payables Processing System

- Purchases
  - Request for Proposals
  - Inventory Status Reports
- Receiving
  - Receiving Report
- Payables
  - Disbursements Voucher File
- Preparing Analyses & Reports
- Handling Purchase Returns & Allowances
  - Debit Memorandum
Cash Disbursements Processing System

- Processing Petty Cash disbursements
  - Imprest System
- Disbursing cash for miscellaneous purposes
Managerial Decisions Pertaining to the Expenditure Cycle - I

 Inventory Decisions

- What levels of merchandise inventory should be stocked?
- When should particular inventory be reordered?
- What quantities of particular inventory items should be reordered?
- When should long term purchase contracts be obtained for particular inventory items?
Inventory Decisions (Continued)

- Which suppliers should be established as long-term sources of merchandise and supplies?
- From which suppliers should particular inventory items be ordered?
- What procedures should be followed in receiving and storing merchandise inventory?
- What organizational units are to be included in the inventory management and logistics function?
- What logistics plans and budgets are to be established for the coming year?
Managerial Decisions Pertaining to the Expenditure Cycle - III

- Financial Decisions
  - What policies concerning purchase terms and discounts should be established?
  - What level of service should departments be allowed to inquire?
  - What accounts payable records are to be maintained concerning amounts owed to suppliers?
  - What financial plans and budgets are to be established for the coming year?
  - What sources of funds are to be employed?
Operational Listings & Reports

- Voucher Register
- Check Register
- Open Purchase Order Report
- Open Invoices Report
- Inventory Status Report
- Overdue Deliveries Report
Scheduled Managerial Reports

- A Payables Aging Report
- Purchase Analyses
- Vendor Performance Report
- Cash-flow Statement
- Critical Factors Report
Data Management: File Oriented Approach

- Master Files
  - Supplier/Vendor Master File
  - Accounts Payable Master File
  - Merchandise Inventory Master File

- Transaction & Open Document Files
  - Purchase Order File
  - Open Purchase Order File
  - Supplier’s Invoice File
  - Open Vouchers File
  - Cash Disbursements File

- Other Files
  - A Supplier Reference & History File
  - A Buyer File
  - An Accounts Payable Detail File
### A Layout of a Supplier (Accounts Payable) Record

<table>
<thead>
<tr>
<th>Supplier Account Number</th>
<th>Supplier Name</th>
<th>Mailing Address</th>
<th>Phone Number</th>
<th>Credit Terms</th>
<th>Year-to-date Purchases in total</th>
<th>Year-to-date Payments in total</th>
<th>Current Account Balance</th>
</tr>
</thead>
</table>

Figure 13-17
Control Objectives - I

- All purchases are authorized on a timely basis when needed and are based on EOQ calculations
- All received goods are verified to determine that the quantities agree with those ordered and that they are in good condition
- All services are authorized before being performed and are monitored to determine that they are properly performed
Control Objectives - II

- All suppliers’ invoices are verified on a timely basis and conform with goods received or services performed
- All available purchase discounts are identified, so that they may be taken if economical to do so
- All purchase returns and allowances are authorized and accurately recorded and based on actual return of goods
Control Objectives - III

All cash disbursements are recorded completely and accurately

All credit purchases and cash disbursements transactions are posted to proper suppliers’ accounts in the accounts payable ledger

All accounting records and merchandise inventory are safeguarded
## Risk Exposures Within the Expenditure Cycle - I

<table>
<thead>
<tr>
<th>Risk</th>
<th>Exposure(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) Orders placed for unneeded goods or more goods than needed</td>
<td>1) Excessive inventory and storage costs</td>
</tr>
<tr>
<td>Receipt of uncoded goods</td>
<td>2) Excessive inventory and storage costs</td>
</tr>
<tr>
<td>3) No receipt of ordered goods</td>
<td>3) Losses due to stockouts</td>
</tr>
<tr>
<td>4) Fraudulent placement of orders by buyers with suppliers to whom they have personal or financial attachments</td>
<td>4) Possibility of inferior or overpriced goods or services</td>
</tr>
<tr>
<td>Risk</td>
<td>Exposure(s)</td>
</tr>
<tr>
<td>---------------------------------------------------------------------</td>
<td>----------------------------------------------------------------------------</td>
</tr>
<tr>
<td>5) Creation of fictitious invoices and other purchasing documents</td>
<td>5) Overstatement of inventory; losses of cash disbursed</td>
</tr>
<tr>
<td>6) Lack of vigilance in writing down inventory that is aged or</td>
<td>6) Overstatement of inventory</td>
</tr>
<tr>
<td>damaged</td>
<td></td>
</tr>
<tr>
<td>7) Omission of liabilities, such as material contingencies</td>
<td>7) Understatement of liabilities</td>
</tr>
<tr>
<td>8) Overcharges (with respect either to unit prices or to quantities)</td>
<td>8) Excessive purchasing costs</td>
</tr>
<tr>
<td>by suppliers for goods delivered</td>
<td></td>
</tr>
</tbody>
</table>
## Risk Exposures Within the Expenditure Cycle - III

<table>
<thead>
<tr>
<th>Risk</th>
<th>Exposure(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>9) Damage to goods enroute to the acquiring firm</td>
<td>9) Possibility of inferior goods for use or sale</td>
</tr>
<tr>
<td>10) Errors by suppliers in computing amounts or invoices</td>
<td>10) Possibility of overpayment for goods received</td>
</tr>
<tr>
<td>11) Erroneous or omitted postings of purchases or purchase returns to supplier’s accounts payable records</td>
<td>11) Incorrect balances in accounts payable and general ledger account records</td>
</tr>
<tr>
<td>12) Errors in charging transaction amounts to purchases and expense accounts</td>
<td>12) Incorrect levels (either high or low) for purchases and expense accounts</td>
</tr>
<tr>
<td>Risk</td>
<td>Exposure(s)</td>
</tr>
<tr>
<td>----------------------------------------------------------------------</td>
<td>----------------------------------------------------------------------------</td>
</tr>
<tr>
<td>13) Lost purchase discounts due to late payments</td>
<td>13) Excessive purchasing costs</td>
</tr>
<tr>
<td>14) Duplicate payments of invoices from suppliers</td>
<td>14) Excessive purchasing costs</td>
</tr>
<tr>
<td>15) Incorrect disbursements of cash, either to improper or fictitious parties or for greater amounts than approved</td>
<td>15) Loss of cash and excessive costs for goods and services</td>
</tr>
</tbody>
</table>
### Risk Exposures Within the Expenditure Cycle - V

<table>
<thead>
<tr>
<th>Risk</th>
<th>Exposure(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>16) Improper disbursement of cash for</td>
<td>16) Excessive costs for goods or services</td>
</tr>
<tr>
<td>goods or services not received</td>
<td></td>
</tr>
<tr>
<td>17) Theft of scrap proceeds</td>
<td>17) Loss of cash</td>
</tr>
<tr>
<td>18) Disbursement of checks payable to</td>
<td>18) Loss of cash</td>
</tr>
<tr>
<td>employees for unauthorized expenses or</td>
<td></td>
</tr>
<tr>
<td>fraudulent claims</td>
<td></td>
</tr>
<tr>
<td>19) Fraudulent alteration and cashing of</td>
<td>19) Loss of cash</td>
</tr>
<tr>
<td>checks by employees</td>
<td></td>
</tr>
<tr>
<td>20) Kiting of checks by employees</td>
<td>20) Overstatement of back balances; possible losses of deposited cash</td>
</tr>
</tbody>
</table>

*Figure 13-20 Continued*
### Risk Exposures Within the Expenditure Cycle - VI

<table>
<thead>
<tr>
<th>Risk</th>
<th>Exposure(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>21) Accessing of supplier records by unauthorized persons</td>
<td>21) Loss of security over such records, with possible detrimental use made of data accessed</td>
</tr>
<tr>
<td>22) Involvement of cash, merchandise inventory, and accounts payable record in natural or human-made disasters</td>
<td>22) Loss of or damage to assets, including possible loss of data needed to monitor payments of amounts due to suppliers within discount periods</td>
</tr>
<tr>
<td>23) Interception of data transmitted via the Web</td>
<td>23) Loss of data or unreliable data resulting in inaccurate purchase orders</td>
</tr>
<tr>
<td>24) Unauthorized purchase requisitions and purchase orders initiated via the Web</td>
<td>24) Excessive inventory and storage costs</td>
</tr>
</tbody>
</table>
## Risk Exposures Within the Expenditure Cycle - VII

<table>
<thead>
<tr>
<th>Risk</th>
<th>Exposure(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>25) Unauthorized viewing and alteration of a company’s purchase records via the Web</td>
<td>25) Loss of security over data which can be used to the detriment of the company</td>
</tr>
<tr>
<td>26) Breakdown of the Web server due to unexpected events</td>
<td>26) Loss of data and delay in processing purchase orders</td>
</tr>
</tbody>
</table>
General Controls - I

- Organizational Controls
- Documentation Controls
- Asset Accountability Controls
- Management Practices Controls
  - Training & Bonding of employees
  - Systems development & changes subject to prior approvals, testing, and sign-off
  - Audits on purchases and cash disbursements
  - Periodic review and analyses of account activity and computer-approved transactions
General Controls - II

- Data Center Operations Controls
- Authorization Controls
- Access Controls
  - Assigned passwords required in order to access accounts payable and other supplier-related files
  - Terminals restricted in their functions with respect to purchases and cash disbursement transactions
  - Logging of all purchases and cash disbursement transactions upon their entry into the system
  - Frequent dumping of accounts payable and merchandise inventory master files onto magnetic tape backup
  - Physically protected warehouses
  - Logs that monitor all accesses of data stored in files
Application Controls Pertaining to the Expenditure Cycle: Input Controls

1) Prepare pre-numbered and well-designed documents relating to purchases, receiving, payables, and cash disbursements

2) Validate data on purchase orders and receiving reports and invoices as the data are prepared and entered for processing

3) Correct errors that are detected during data entry and before the data are posted to the supplier and inventory records

4) Pre-compute batch control totals relating to key data on suppliers’ invoices and vouchers due for payment
Application Controls Pertaining to the Expenditure Cycle: Processing Controls

1) Issue purchase requisitions, purchase orders, disbursement vouchers, checks, and debit memoranda on the basis of valid authorizations

2) Verify all data elements and computations on purchase requisitions and on purchase orders

3) Vouch all data elements and computations on suppliers’ invoices

4) Monitor all open transactions, such as partial deliveries and rejected goods

5) Issue debit memoranda only on the basis of prior approval of the purchasing or other appropriate manager
6) Reconcile amounts in the accounts payable subsidiary ledger and expense ledgers with control accounts in the general ledger

7) Verify that total postings to the accounts payable file accounts agree with the total postings to the general ledger accounts

8) Monitor discount terms relating to payment

9) Review evidence supporting the validity of expenditures and the correctness of amounts prior to the signing of checks

10) Use check protectors to protect the amounts on checks against alteration before the checks are presented to be signed
11) Require that checks over a specified amount be countersigned by a second manager

12) Verify all inventories on hand by physical counts once yearly, and reconcile the counted quantities with the quantities shown in the inventory records

13) Use imprest systems for disbursing currency from petty-cash funds, with the funds being subject to surprise counts by internal auditors or a designated manager
14) Establish purchasing policies that require competitive bidding for large and/or non-routine purchases and that prohibit conflicts of interest.

15) Correct errors that are made during processing steps, usually by reversing erroneous postings to accounts and entering correct data.
Application Controls Pertaining to the Expenditure Cycle: Output Controls

- 1) establish clear-cut receiving and payables cut-off policies, so that inventories and accounts payable are fairly valued at the end of each accounting period
- 2) Establish budgetary control over purchases, with periodic reviews of actual purchase costs and such key factors as inventory turnover rates
- 3) Compare monthly statements from suppliers with the balances appearing in the suppliers’ accounts in accounts payable
Application Controls Pertaining to the Expenditure Cycle: Output Controls

4) File copies of all documents pertaining to purchases and cash disbursements by number; including voided documents such as checks

5) Print transaction listings in order to provide an adequate audit trail
Programmed Edit Checks Useful in validating Transaction Data in the Expenditure Cycle

- Validity check
- Self-checking digit
- Field check
- Limit check
- Range check
- Relationship check
- Sign check
- Completeness check*
- Echo checks*

* = applicable only to online systems
Web Security Procedures

- Authentication
- Authorization
- Accountability
- Data Transmission
- Disaster Contingency & Recovery Plan