**Chapter-Five**

**Audit of Purchase, Accounts payable, and other Liabilities**

 **5.1: Sources of purchase**-Audit of purchases is a significant part of independent financial audit because the purchases constitute the largest item of expense in the income summary of an organization. Purchase transaction might be resulted from different sources such as purchase of materials, merchandise, fixed assets of various types etc

**5.2: Auditors objectives in auditing purchases**

The auditor’s objectives in the audit of purchases are:

1. Consider the **internal control** over purchases
2. Determine the **existence** of purchases
3. Establish the **completeness** of the
4. Determine that the client has the **rights** to the recorded purchases
5. Establish the **clerical accuracy** of the records and supporting schedules of purchases
6. Determine the **valuation** of purchases
7. Determine that the **presentation and disclosure** of inventories and cost of goods sold is adequate including disclosure of classification of inventories, accounting methods and any inventories pledged as collateral for loans.

**5.3: Audit program for Purchase**- The audit program for purchase transactions also deal with two types of procedures

**(A)** Procedures applied to internal control of the company over different purchase transactions and

**(B)** Substantive testing procedures applied to a sample of purchase transactions and account balances.

**5.3.1: Consideration of internal control over purchases**

The auditor studies and evaluates the accounting systems and internal controls relating to purchases. It helps the auditor to determine the **nature, extent, and timing** of the substantive procedures. The auditor seeks to obtain an understanding the flow of transactions while analyzing the internal control system and the accounting of purchases.

The following procedures are typical of the work required in many engagements for the verification of purchase transactions

**A) Consider internal control over purchases**

**1.** *Obtain an understanding of internal control over purchases*

 Auditors may use written description, flow chart or internal control questionnaire to describe the nature of client’s internal control structure. After preparing description of internal control, the auditors will determine whether the controls as described to them have been placed in operation, whether there is appropriate segregation of duties and considered the misstatements that may occur.

***2.*** *Assess control risk and design additional tests of control for the assertions*

 *about purchase transactions.*

Based on an understanding of the client’s internal control over purchase, the auditors develop their planned assessed level of control risk for the various financial statement assertion and obtain additional evidences of the operating effectiveness of the client’s controls by designating additional tests of control.

***3****. Perform additional tests of controls for those controls that the auditors plant to consider to support their planned assessed levels of control risk.*

As auditors obtain an understanding of the client’s internal control; certain tests of control are performed.

E.g. select a sample of purchase transactions to test the control related to authorization, proper recording, etc of the transactions.

**4**. *Reassess control risk for each of the major financial statements assertions about purchase transactions based on the results of tests of controls and, if necessary, modify substantive tests.*

The internal control relating to purchases can be studied and evaluated by segregating the purchase cycle into four segments. They are:

1. Processing of purchase orders.
2. Receiving of goods.
3. Recognizing the liability of purchase.
4. Processing and recording of payments.

**A)** **Processing of Purchasing Orders**:

The auditor has to examine the internal control related to processing, purchase orders and should understands

* Whether the purchases are centralized or decentralized.
* Whether the purchase procedure provide for the preparation of the return purchase requisition
* Whether the purchase requisition are prepared in a standard format
* Whether the standard format requires furnishing of sufficient details about quantity required, technical specification, delivery schedule etc.
* Whether the authorities regarding sanctioning of purchases have been clearly laid down with proper authority.
* Whether a list of approved suppliers maintained for each major item
* Whether purchases are made from approved suppliers
* Whether tenders and quotations are invited from suppliers
* Whether any long term purchase contracts have been entered into with suppliers and if so, whether the provision in the contract is clear and unambiguous.
* Whether any undue advantage is given to any supplier
* Whether any special authorization required in case of lowest quotation accepted.
* Whether there is any system for approving the prices and other terms and conditions in case of purchases, which are not made on quotations.
* Whether any purchases are made from organizations in which the related parties are interested.
* Whether the purchase orders are pre-numbered and kept in the proper custody.
* Whether the purchase orders are made in detail and precise
* Whether the copy of the purchase order required to be signed by the supplier significant his acceptance of the terms of the order.
* Whether a copy of the purchase order is forwarded to the receiving and inspection department and to the accounting department.
* Whether any periodic review has been done on the purchase order, which remained, unexecuted beyond the due dates.

**B)** **Receiving goods**:

* Whether all the goods are received only in the receiving department and if not whether there is any procedure for obtaining conformations about the quantity and quality of the goods received
* Whether goods received note is prepared when the materials are received.
* Whether the goods received note are pre-numbered
* Whether there is any procedure for verifying the quantities and the quality of the materials at the time of receipt
* Whether there is any procedure for verifying the specifications given in the purchase order with that of the materials received.
* Whether any system exist for the receiving department to reject the material if there is any variation in the goods received with that of the purchase order.
* Whether there is any procedure for the receiving department to inform the accounts department, purchase department, and stores with regard to the receipt of materials
* Whether the materials received are promptly sent to the stores.

**C)** **Recognizing the liability for purchase**:

* Whether the supplier’s invoices received by the accounting department and matched with the purchase order, good received note and advance payment records.
* Whether the invoices are checked thoroughly to ensure the terms and conditions of the purchase order have been complied with.
* Whether the invoices are checked for arithmetical accuracy
* Whether invoices are entered promptly in the purchase book
* Whether proper debit notes are prepared for any variations in quantity and quality of the materials received with those specified in the purchase order.
* Whether the debit notes are pre-numbered
* Whether the debit notes are issued with proper authority
* Whether the debit notes are entered in the proper books.
* Whether duplicate invoices are accepted when original invoices are accepted with proper authority
* Whether the advances are made only as per the terms of the purchase order and with proper authority.
* Whether all advances are reviewed periodically and properly followed up
* Whether there is any periodic reconciliation of goods paid for and goods received as per stores record.

**D)** **Processing and recording of Payments**:

The internal control procedures for processing and recording of payments have being already seen while discussing audit of cash and marketable securities.

**E) Overall controls**

1. Whether there is any **proper segregation of duties** in relation to the activities involved in purchase.
2. Whether there is any **system for the rotation of duties** of personnel involved in the purchase transaction.
3. Whether there is a **proper procedures for cut off transactions**
4. Whether there is any **proper procedure for returning the purchases**.
5. Whether there is any **internal audit in respect of the purchase cycle.**
6. Whether there is any **system for sending periodic statement of accounts to the suppliers.**

 **(B) Substantive testing procedures applied to a sample of purchase transactions and account balances.**

The auditor determines the **nature**, the timing, and the **extent** of substantive procedures relating to purchases on the basis of the auditors’ assessment of the **inherent risk** of misstatement of purchases in the financial statements and his evaluation of the **internal control system**. The procedures may involve

1. Tests of individual transactions and purchase.
2. Analytical procedures
3. Presentation and disclosures.
	1. **Tests of individual transactions and purchase:**

The auditor has to

* Examine the entries in the purchase book with reference to the invoices and supporting documents such as goods received note, inspection reports, etc.
* Examine a sample of invoices selected at random and conduct an in-depth audit.
* Examine the numerical sequence of purchase orders and goods received note and determine whether all the members are duly accounted.
* Examine the Arithmetical accuracy of the purchase records and check the totals, balances, and their carry forwards.
* Examine the entries in the purchase return book and examine Arithmetical accuracy
* Examine whether proper adjustments have been done for the debit notes.
* Examine whether the debit notes are issued with proper authority.
* Examine the debit notes issued at the year-end, which appear unusual.
* Examine the numerical sequence of the debit notes and see whether all debit notes are duly accounted.
* Examine the sales invoice of goods directly delivered to the third parties.
* Examine the cutoff transactions relating to purchases and purchase returns.
* Examine the response of the suppliers to the periodic statement of accounts sent by the client.
* Obtain the conformation of balance form the suppliers.
	1. **Analytical Procedures:**

**The following are the analytical procurers adopted by the auditors in respect of purchases**.

* Compare the purchase figures of different periods of the current year and enquire into the unusual fluctuations.
* Prepare a reconciliation statement for the quantities of purchases.
* Compare the budgeted purchases with the actual purchases.
* Compare current years purchase figures with those of the previous years.
* Compare the ratios of value of each item to the total purchases for the current year with the figures of the previous year.
* Compare the gross profit ratio for the current year with the ratio of the previous year and with the industry average.

The auditor examines the result of the application of the analytical procedure to identify any **unusual fluctuations** or **variations** and satisfy himself to form an opinion.

* 1. **Examination of presentation and disclosure**: The auditor has to examine the presentation and disclosure of purchases with the financial statements in accordance with the generally accepted accounting principles. He has to also examine whether the purchases have been properly classified and disclosed under the appropriate account heads. The presentation and disclosure should also be in accordance with the provisions of the various statutes if any exist in the country.
	2. **Imports**: The auditor has to apply the following substantive procedure if the purchases are made out of imports.
* Examine whether the imports have been made in accordance with the relevant legal provisions.
* Examine the documents such as bill of lading import clearance certificate receipt for the payment of customs duty
* Examine the evidence of the approval of the concerned authorities for the remittance of foreign currency.
* Examine the transactions of imports are properly recorded in the books and the amount has been properly converted into local currency.

**Forward Contracts:**

 A forward contract for purchase is an agreement to purchase certain items at a future date at an agreed price. The objective of forward contract for purchase from the viewpoint of the buyer is to cover himself against possible increase in price in future. The auditor has to pay a special attention to the forward contract for purchases. The auditor should examine these forward contracts for purchases carefully as they represent a future liability for the enterprise. If the prices fall in future, the organization may tend to incur a loss and, hence the auditor has to examine whether proper provision has been made in the financial statements. If the professional body of accountants had issued any guidelines in respect of such transactions or if any statute contains any provisions in respect of these transactions, the auditor has to examine whether these provisions or guidelines are strictly complied with.

**5-5: Audit of accounts payables, payrolls and other liabilities**

**5-5-1: Audit Of Accounts payable**-The term accounts payable often referred to as vouchers payable for a voucher system) is used to describe short-term obligations arising from the purchase of goods and services in the ordinary course of business. Typical transactions creating accounts payable include the acquisition on credit of merchandise raw materials, plant assets, and office supplies. Other sources of accounts payables include the receipt of services, such as legal and accounting services advertising, repair and utilities.

Invoices and statements from suppliers usually evidence accounts payable arising from the purchase of goods or services and most other liabilities.

**The auditors’ approach to auditing accounts payables and other related liabilities**

The auditors’ objectives in the audit of accounts payables are to:

1. **Consider internal control** over accounts payables and other liabilities
2. Determine the **existence** of recorded accounts payable and other liabilities
3. Establish the **completeness** of recorded accounts payables and other liabilities.
4. Determine that the **valuation** of accounts payable is in accordance with generally accepted accounting principles
5. Establish the **clerical accuracy** of schedules of accounts payables
6. Determine that the **presentation and disclosure** of accounts payable are appropriate.

**Audit program for accounts payables**

The following procedures are typical of the work required in many engagements for the verification of accounts payables.

**A. Consider internal control over accounts payables**.

**1.** Obtain an understanding of internal control over accounts payables

**2.** Assess control risk for each the major financial assertions about accounts payables, and design additional tests of controls.

**3.** Perform additional tests of control for those controls that the auditors plan to consider to support their planned assessed levels of control risk.

(a) Verify a sample of posting to the accounts payables accounts.

(b) Vouch to supporting documents a sample of postings in selected accounts of the account payable subsidiary ledger.

(c) Test computer applications controls if any.

**4**. Reassess control risk for each of the major financial statements assertions about accounts payables based on the results of the tests of controls and modify substantive tests.

**B. Perform substantive tests of accounts payables transactions and balances with their primary audit objectives.**

**5.** Obtain or prepare trial balances of accounts payables as of the balance sheet data and reconcile with the general ledger (**To test clerical accuracy**)

**6.** Vouch balances payable to selected creditors by inspection of supporting documents

 (**To test existence; obligation and valuations**)

|  |  |
| --- | --- |
| 1. Reconcile liabilities with monthly statements from creditors
2. Confirm accounts payables by direct correspondence with venders
3. Perform analytical procedures for accounts payables and related accounts

 | **Completeness****existence** and **obligation****Valuation** |
| 1. Search for unrecorded accounts payables
 | **completeness** |
| 1. Perform procedures to identify accounts payables to related parties
2. Evaluate proper balances sheet presentation and disclosure of accounts payables
 | **presentation** and **disclosure** |

NB. Other liabilities such as amounts withheld from employees’ pay, sales taxes payable, unclaimed wages, customers’ deposits, accrued liabilities and the like should also be considered by auditors. Thus, auditors also need to apply the necessary audit procedures with these respects.

 **5-5-2: Audit of payroll liabilities**

The payroll in many companies is by far the largest operating cost and therefore, deserves the close attention of the auditors. In the past, payroll frauds were common and often substantial. Today, however, such frauds may be more difficult to conceal for several reasons such as:

* + 1. Extensive subdivision of duties relating to payroll;
		2. Use of computer, with proper controls, for preparation of payrolls; and
		3. Necessity of filing frequent reports to the environment, listing employees’ earnings and tax will withholdings.

**Audit program for payrolls-** The audit program for payroll is also classified in to two major sections: **(A)** Consideration of internal control and **(B)** Application of substantive testing procedures

**A) Internal control over payroll**-The establishment of strong internal control over payrolls is partially important for several reasons. Although payroll frauds are less frequent, today, the possibilities of large scale payroll frauds still exists. Such frauds may involve **listing of fictitious persons on the payroll**, **overpaying employees**, and **continuing employees on the payroll** after their separation from the company.

A second reason for emphasizing internal control over payroll is that a great mass of detailed information concerning hours worked and rates of pay must be processed quickly and accurately if workers are to be paid promptly and without error. Maintaining good employee relations demands that pay checks be ready on time and be free from errors. Internal control here is therefore a means of securing accuracy and dependability in accounting data as well as a means of preventing fraud.

Still another reason for emphasizing the importance of internal control over payrolls is the existence of various payroll tax and income tax laws which require the certain payroll records be maintained and that payroll data be reported to the employee and to government agencies. Complete and accurate records of time worked are also necessary if a company is to protect itself against lawsuits country’s labor law.

**Methods of achieving internal control over payroll**

**Budgetary controls** -of labor costs-to control payroll costs to avoid wastes and to obtain the maximum production from the dollars expended for services of employees. As a means of establishing control over payroll costs, many companies delegate to departments heads and other supervisors responsibilities for the control of costs in their respective units of the business. The supervisors may be requested at the beginning of each period/year/to submit for the budget an estimate of departmental labor costs for the coming period against which actual labor costs will be compared and significant departure if any will be investigated and the necessary corrective action could be taken.

**Reports to government agencies**-Another important internal control over payroll lies in the necessity of preparing reports to government agencies, showing the earrings and tax deduction for all employees. This type of control is not concerned with holding labor costs to a minimum but is an effective means of preventing and detecting payroll frauds.

**Subdivision of duties**-payroll activities include the function of employment, time keeping, payroll preparation and record keeping, and the distribution of pay to employees. For effective internal control each of these functions should be handled by a separate department of the company. Combination of these functions in a single department or under the authority of one person opens the door to payroll fraud.

 **Description of internal control for payroll-**Typical of the questions to be answered by the auditors for the completion of an internal control questionnaire, a systems flowchart, or other record of payroll internal control are the following.

* Are employees paid by checks or direct deposit?
* Is a payroll bank account maintained on an important basis?
* Are the activities of timekeeping, payroll compilation, payroll check signing, and paycheck distribution/cash payments/ performed by separate departments or employees.
* Are all operations involved in the preparation of payrolls subject to independent verifications before the paychecks are distributed?
* Are employees time reports approved by supervisors?
* Is the payroll bank account reconciled monthly by employees having no other payroll duties?

**B) Substantive testing procedures over payrolls**

The following substantive procedures are representative of the works generally completed to establish the propriety of payments for salaries, wages, bonuses and commissions

1. Perform substantive tests of over payrolls transactions for selected pay periods, including the following specific procedures:
	1. Compare names and wages or salary rates to records maintained by the personnel department
	2. Compare time shown on payroll to time cards and time reports approved by supervisors.
	3. If payroll is based on piecework rates rather than hourly rates, reconcile earnings with procedures records.
	4. Determine basis of deductions from payroll and compare with records o deductions authorized by employees.
	5. Test extensions and footings of payroll
	6. Compare total of payroll with total of payroll checks issued.
	7. Compare total of payroll with total of labor cost summary prepared by cost accounting department.
	8. If wages are paid in cash, compare receipts obtained from employees with payroll records.
	9. If wages are paid by check, compare paid checks with payroll and compare endorsements to signatures on withholding tax exceptions certificates.
	10. Observe the use of time clocks by employees reporting for work and investigate time cards not used.

**2.**Perform analytical procedures to test the reasonableness of payroll expenses; for example, developing an expectation about the amount of payroll expense by multiplying the amount of one pay period by the number of pay periods in the year.

**3.** Investigate any extraordinary fluctuations in salaries, wages and commissions.

**4.** Obtain or prepare a summary of compensation of officers for the year and compare to contracts, minutes of directors, meetings, or other authorizations.

**5.** Test commission earnings by examination of contracts and detailed supporting records.

**6.** Test pension obligations by reference to authorization pension plans and to supporting documents.

In addition to the above procedures, the auditors may plan a surprise observation of regular distributions of pay checks to employees. The auditors’ objective in observing the distribution of checks or cash to employees on a regular payday is to determine that every name on the company payroll is that of a bona fide employee presently on the job. These audit payroll works are not sufficiently segregated by departments to afford good internal control.

**Objectives of major substantive tests of payrolls**

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|  **Substantive Tests**  | **Primary Audit objectives** |
| * Perform analytical procedures
* Investigate fluctuations in salaries, wages, and commissions
* Obtain a summary of amounts of officers

 compensations and trace to authorizations | **Existence** or **occurrence****completeness** and **valuation** |
| * Test computations of compensations under profit sharing or bonus plans
* Test commissions earrings
* Test pension obligations
 | **Valuations** |