

CHAPTER 9

The Why and How of Auditing Payables/Expenses

Accounts payable is usually one of the more important audit areas. Why? Risk. First, it's easy to increase net income by not recording period-end payables. Second, many forms of theft occur in this area.

In this chapter, we'll answer questions such as, "How should we test accounts payable?" And "Should we perform fraud-related expense procedures?" We'll also take a look at common accounts payable risks and how to respond to them.

Auditing Accounts Payable and Expenses — An Overview

What is a payable? It's the amount that a company owes for services or goods received. Suppose a company receives \$2,000 in legal services in the last week of December 20X3, but the law firm sends the related invoice in January 20X4. The company owes \$2,000 as of December 31, 20X3. The services were provided, but the payment was not made until after the year-end. Consequently, the company should accrue the \$2,000 as payable at year-end.

In determining whether payables exist, I like to ask, "If the company closed down at midnight on the last day of the year, would it have a legal obligation to pay for a service or good?" If the answer is yes, then record the payable even if the invoice is received after the year-end.

In this chapter, we will cover the following:

- Primary accounts payable and expense assertions
- Accounts payable and expense walkthroughs
- Directional risk for accounts payable and expenses
- Primary risks for accounts payable and expenses
- Common accounts payable and expense control deficiencies
- Risks of material misstatement for accounts payable and expenses
- Substantive procedures for accounts payable and expenses
- Common accounts payable and expense work papers

Primary Accounts Payable and Expense Assertions

First, let's look at assertions. The primary relevant accounts payable and expense assertions include:

- Existence
- Completeness
- Cutoff
- Occurrence

Of these assertions, I believe completeness for payables and expenses, cutoff for payables and expenses, and occurrence for expenses are usually most important. When a company records its payables and expenses by period-end, it is asserting that they are complete and that they are accounted for in the right period. Additionally, the company is implying that recorded expenses are legitimate, i.e., that they occurred.

Accounts Payable and Expense Walkthroughs

Second, perform your risk assessment work in light of the potential relevant assertions. In performing accounts payable and expense walkthroughs, ask questions such as:

- Who reconciles the accounts payable summary to the general ledger?
- Does the company use an annual expense budget?
- Are budget/expense reports provided to management or others? Who receives those reports?
- What controls ensure the recording of payables in the appropriate period?
- Who authorizes purchase orders? Are any purchases authorized by means other than a purchase order? If yes, how?
- Are purchase orders electronic or physical?
- Are purchase orders numbered?
- How does the company vet new vendors?
- Who codes invoices (specifies the expense account) and how?
- Is a three-way match performed that is a comparison of the purchase order with the receiving document and the invoice?
- Are paid invoices marked “paid”?
- Does the company have a purchasing policy?
- Can credit cards be used to bypass standard purchasing procedures? Who has credit cards and what are the limits? Who reviews credit card activity?
- Are bids required for certain types of purchases or dollar amounts? Who administers the bidding process and how?
- Do larger payments require multiple approvals?
- Which employees key invoices into the accounts payable software?
- Who signs checks or makes electronic payments?
- Who is on the bank signature card?
- Are signature stamps used? If yes, who has control of the signature stamps and whose signature is affixed?

- How are electronic payments made (e.g., ACH)?
- Is there adequate segregation of duties for persons approving purchases, making payments, recording payables, and reconciling the related bank statements
- Which persons have access to check stock and where is the check stock stored?
- Who can add vendors to the payables system?
- What are the entity's procedures for payments of travel and entertainment expenses?
- Who reconciles the bank statements and how often?
- Are payees on cleared checks compared to the general ledger postings?

As we ask these questions, we inspect documents (e.g., payables ledger) and make observations (e.g., who signs checks or makes electronic payments?).

If control weaknesses exist, we create audit procedures to respond to them. For example, if—during the walkthrough— we see that one person prints and signs checks, records payments, and reconciles the bank statement, then we will perform fraud-related substantive procedures.

Directional Risk for Accounts Payable and Expenses

Third, consider the directional risk of accounts payable and expenses.

The directional risk for accounts payable and expenses is that they are understated. Perform procedures to ensure that invoices are properly included. For example, perform a search for unrecorded liabilities, as detailed below.

Primary Risks for Accounts Payable and Expenses

Fourth, think about the risks related to accounts payable and expenses. The primary risks for accounts payable and expenses include:

- Accounts payable and expenses are intentionally understated
- Payments are made to inappropriate parties
- Duplicate payments are made to vendors
- Inflated amounts are paid to vendors (after company employees receive kickbacks)
- Management does not follow bid policy requirements

Common Accounts Payable and Expense Control Deficiencies

Fifth, think about control deficiencies noted during your walkthroughs and other risk assessment work. In smaller entities, it is common to have the following control deficiencies:

- One person performs two or more of the following:
 - Approves purchases
 - Enters invoices in the accounts payable system
 - Issues checks or makes electronic payments
 - Reconciles the accounts payable bank account
 - Adds new vendors to the accounts payable system
- A second person does not review payments before issuance
- No one performs surprise audits of accounts payable and expenses
- Bidding procedures are weak or absent
- No one reconciles the accounts payable detail to the general ledger
- New vendors are not vetted for appropriateness
- The company does not create a budget
- No one compares expenses to the budget

- Bank accounts are not reconciled on a timely basis
- When bank accounts are reconciled, no one examines the canceled checks for appropriate payees (no one compares the payee name on the cleared check to the vendor name in the general ledger)

When segregation of duties is lacking, consider whether someone can use the expense cycle to steal funds. How? Examples include making payments to fictitious vendors or intentionally paying a vendor twice—and then stealing the second check.

Risks of Material Misstatement for Accounts Payable and Expenses

Sixth, assess the risks of material misstatement in light of the information you've gathered.

The assertions that concern me the most are completeness, occurrence, and cutoff. So my RMM for these assertions is usually moderate to high.

My response to higher risk assessments is to perform certain substantive procedures: namely, a search for unrecorded liabilities and detailed expense analyses. The particular expense accounts that I examine are often the result of my preliminary planning analytics. (See Appendix A for a detailed look at preliminary analytics.)

Substantive Procedures for Accounts Payable and Expenses

And finally, it's time to determine your substantive procedures in light of your identified risks.

My customary audit tests are as follows:

- Perform a search for unrecorded liabilities
- Compare expenses to budget or prior year balances and

examine any unexplained variances

- When control weaknesses are present, consider designing and performing fraud detection procedures

Controls can be tested for accounts payable processing. If controls are effective, then some substantive procedures may not be necessary.

How does one perform a search for unrecorded liabilities? Perform the following steps:

1. Obtain a complete check register for the period subsequent to your audit period
2. Pick a dollar threshold in light of materiality (e.g., \$5,000)
3. Examine the subsequent payments (above the threshold) and related invoices to determine if the payables are suitably included in or excluded from the period-end accounts payable detail
4. Inquire about any unrecorded invoices

As the RMM for completeness increases, vouch payments at a lower dollar threshold.

How should you perform a detailed analysis of expense accounts? First, compare the expenses to budget—if the entity has one—or to prior year balances. If you note any significant variances that can't be explained, then obtain a detail of those particular expense accounts and investigate the cause.

Theft can occur in numerous ways such as fictitious vendors or duplicate payments. If control weaknesses are present, consider performing fraud-related procedures. When fraud-related control weaknesses exist, assess the RMM for the occurrence assertion at high. Why? There is a risk that the expense (the occurrence) is fraudulent.

An example of a fraud-related test is one for duplicate payments. How?

- Obtain a check register in Excel
- Sort by the vendor
- Scan the check register for payments made to the same vendor for the same amount
- Inquire about payments made to the same vendor for the same amount

In a duplicate payment fraud, the thief intentionally pays an invoice twice. He steals the second check and converts it to cash. This is just one example of expense fraud. There are dozens of such schemes.

If there are going concern issues, you may need to examine the aged payables listing. Why? Management can fraudulently shorten invoice due dates. Doing so makes the company appear more current. For example, suppose the business has three unpaid invoices totaling \$1.3 million that are more than ninety days past due. The company changes the due dates in the accounts payable system, causing the invoices to appear as though they are just thirty days past due. Now the aged payables listing looks better than it should.

Common Accounts Payable and Expense Work Papers

My accounts payable and expense work papers usually include the following:

- An understanding of internal controls as they relate to accounts payable and expenses
- Risk assessment of accounts payable and expenses at the assertion level
- Documentation of any accounts payable and expense control deficiencies

- Accounts payable and expense audit program
- An aged accounts payable detail at period-end
- A search for unrecorded liabilities work paper
- Budget to actual (or prior year to current year) expense reports and, if unexpected variances are noted, a detailed analysis of those accounts
- Fraud-related expense work papers (if significant control weaknesses are present)
- Disclosure checklist

Auditing Payables/Expenses - A Simple Summary

- Primary relevant assertions include completeness and cutoff for payables and expenses and occurrence for expenses
- Perform a walkthrough of the payables/expenses cycle by making inquiries, inspecting documents, and making observations
- The directional risk for payables and expenses is that they are understated
- Primary risks for payables/expenses include:
 - Accounts payable and expenses are intentionally understated
 - Payments are made to inappropriate parties
 - Duplicate payments are made to vendors
 - Inflated amounts are paid to vendors
 - Management does not follow bid policy requirements
- The substantive procedures for payables and expenses should be responsive to the identified risks. Common procedures include:
 - Performing a search for unrecorded liabilities
 - Comparing expenses to budget (or prior year balances) and examining any unexplained variances
 - When control weaknesses are present, designing and performing fraud detection procedures

Now you know how to audit accounts payable and expenses. Next we'll turn our attention to the audit of payroll.