

TOPIC 5

ACQUISITIONS AND PAYMENTS CYCLE

TOPIC OVERVIEW

Goods, services and assets are acquired and paid for in order to continue with business activities that will generate revenue.

The acquisitions and payments cycle includes the following classes of transactions and balances:

Statement of financial position	Statement of comprehensive income
Accounts payable	Credit purchases Cash purchases Purchase returns Discount received Interest on late payments Expenses

The aim of this topic is to explain and apply the activities, functions and documents in the acquisitions and payments business cycle. The risks and internal control in this cycle will also be explained and applied, including internal control over acquisitions and payments transactions in a computerised environment.

This topic is divided into the following learning units:

Learning unit	Title
5.1	Acquisitions and payments cycle
5.1.1	Activities and functions in the cycle
5.1.2	Documents used in the cycle
5.1.3	Risks and internal control in the cycle
5.1.4	Computerisation of the cycle

Learning outcomes

Learning unit	In this topic we focus on the following learning outcomes:	Level
5.1 Acquisitions and payments cycle	<ul style="list-style-type: none"> Describe acquisitions and payments transactions by explaining the activities, functions and documents associated with these transactions. 	2
	<ul style="list-style-type: none"> Identify, explain and evaluate the risks associated with acquisitions and payments transactions and describe and apply the internal controls that could be implemented to mitigate the risks in a noncomputerised environment. 	2
	<ul style="list-style-type: none"> Describe and apply internal control in a computerised environment to acquisitions and payments transactions. 	2

LEARNING UNIT 5.1

ACQUISITIONS AND PAYMENTS CYCLE

INTRODUCTION

Jackson & Stent (2014:11/2) indicate expenditure transactions for different core business processes. As this module is concerned with a normal going concern, the two main activities for expenditure transactions are:

- the ordering and receiving of goods (or services) from suppliers
- the payment of amounts due for the goods ordered and received

5.1.1 ACTIVITIES AND FUNCTIONS IN THE CYCLE

The ordering and receiving of goods from customers and the payment of amounts due to creditors are also referred to as the purchases and payments cycle. The major balance produced by this cycle is accounts payable (including trade creditors).

STUDY

Jackson & Stent (2014:11/2–11/5)

ACTIVITY 1

The following list identifies a number of the functions in a typical trading company:

- 1 Receiving of goods
- 2 Despatch
- 3 Payment preparation
- 4 Marketing
- 5 Production
- 6 Payment and recording of payment
- 7 Recording of purchases
- 8 Personnel
- 9 Ordering of goods
- 10 Wages

REQUIRED

1. Identify, in logical order, the functions that you would normally encounter in the acquisition of and payment for credit purchases in a company.
2. Briefly explain the main activities within the **payment preparation** function in this cycle.

FEEDBACK ON ACTIVITY 1

Reference: Jackson & Stent (2014:11/2-11/5)

1. The functions of the acquisition of and payment for credit purchases are:
 - Ordering of goods
 - Receiving of goods
 - Recording of purchases
 - Payment preparation
 - Payment and recording of the payment

Were you able to list these functions in logical order? Remember to think of practical experiences you encounter on a daily basis. This will make it easier to remember.

2. The main activities relevant to the **payment preparation** function are described in Jackson & Stent (2014:11/12) and are not repeated here.

5.1.2 DOCUMENTS USED IN THE CYCLE

STUDY

Jackson & Stent (2014:11/5–11/6)

ACTIVITY 2

Match the documents explained in your textbook to the functions in the solution to activity 1.

FEEDBACK ON ACTIVITY 2

Function	Document
Ordering of goods	Requisitions Purchase order forms
Receiving of goods	Supplier's delivery note Goods received note
Recording of purchases	Purchase invoice Credit note

Payment preparation	Creditor's statement Cheque (payment) requisition
Payment and recording of the payment	Remittance advice Cheque or electronic payment Receipt

It is important to know which documents are used in the different functions and business cycles for you to be able to design internal controls appropriately. Note that various **logs and variance reports** exist that could be produced for any of the functions and at any stage in the acquisitions and payments cycle.

In addition to the above documents, **accounting records**, such as a purchase journal, creditors ledger, the general ledger (creditors control account), and a purchases returns and allowances journal are also used in the acquisitions and payments cycle. These records are normally maintained in the accounting department.

5.1.3 RISKS AND INTERNAL CONTROL IN THE CYCLE

As stated in the introduction to this topic, the two main activities for expenditure transactions are:

- the ordering and receiving of goods (or services) from suppliers
- the payment of amounts due for the goods ordered and received

The acquisition phase of the cycle attempts to ensure that the company orders and receives only those goods which it requires and that the goods are of a suitable quality and price. The second phase of the cycle attempts to ensure that only goods that have been validly ordered and received are paid for and that payment is authorised, accurate and timeous (Jackson & Stent 2014:11/2). Sound internal controls should be implemented to achieve this.

To derive the internal controls over payments and acquisitions per function and activity in the cycle, you need to apply the **control activities**. The other components of internal control in this cycle are explained separately in Jackson & Stent (2014:11/31).

STUDY

Jackson & Stent (2014:11/6–11/13)

Jackson & Stent (2014:11/31)

ACTIVITY 3

1. Give a system description of the functions, documents and internal controls that can be implemented in the **ordering** department of a going concern. Formulate your answer in the following tabular format:

Functions	Documents	Internal controls

FEEDBACK ON ACTIVITY 3

1. The functions, documents and internal controls that can be implemented in the **ordering** department of a going concern are:

Functions	Documents	Internal controls
1. Initiating orders	1. Requisition	<p>1.1 Before the order is placed, a supervisor/senior buyer should check the order against the requisition for accuracy and authorisation; and review the order for suitability of supplier, reasonableness of price and quantity, and nature of goods being ordered.</p> <p>1.2 The ordering department should file requisitions sequentially and should frequently review the files for requisitions which have not been cross-referenced to an order.</p>
2. Placing orders with suppliers	2. Purchase order form	<p>2.1 Order clerks should not place an order without receiving an authorised requisition and should cross-reference the order to the requisition. Stores/production personnel should confirm that the goods are really needed.</p> <p>2.2 The company should have an approved supplier list to which the buyer should refer when ordering.</p> <p>2.3 A copy of the order should be filed sequentially and the file should be sequence-checked and frequently</p>

		cross-referenced to goods received notes.
		2.4 Blank order forms should be subject to sound stationery controls.

If you were able to perform this activity, you understand what internal controls relating to business cycles are all about. You should be able to perform this for each function in each business cycle.

ACTIVITY 4

Delmundo (Pty) Ltd is a small manufacturing company. The company's accounting functions are carried out by the accounting staff consisting of the accountant, Mary Roosevelt, and two clerical assistants, Stella Stirling and Dean Ramjan. The new owner of the business, John de Marzo, is concerned about a number of processes followed and, not having a business background, has asked you to review and report on certain of these processes. However, his immediate concern is the control over the payment of creditors. To gather first-hand knowledge of how the system currently works, John de Marzo himself compiled an accurate description of the system which he has given to you.

1. When an invoice is received from a supplier, it is promptly entered into the purchase journal by Stella Stirling and filed alphabetically by supplier name. When the supplier's monthly statement arrives, Stella Stirling agrees the invoices received to the statement. She also checks that any payments that were made to the supplier by Delmundo (Pty) Ltd are reflected on the statement.
2. If an invoice reflected on the statement has not been received, Stella Stirling highlights the invoice(s) and marks it "outstanding" on the statement. The full amount reflected on the statement is paid. When the outstanding invoice is received, it is filed with the statement to which it relates and the "outstanding" mark on the statement is crossed out and dated.
3. Using the statements, Stella Stirling then makes a list of all creditors and the amounts which they are to be paid. The list is passed to Mary Roosevelt, who writes out a cheque for each creditor under R5 000. All cheques are carefully written out and marked "not transferable". Mary Roosevelt signs each cheque and returns them with the list to Stella Stirling. Stella Stirling confirms the amounts of each cheque and that there is a cheque for each creditor on the list under R5 000. Stella Stirling writes the cheque number next to each payment on the list and then mails the cheques to the creditors attached to a Delmundo (Pty) Ltd compliment slip. If the amount to be paid is more than R5 000, it is paid by EFT and not by cheque.

4. To pay creditors over R5 000, Mary Roosevelt accesses the electronic funds transfer facility on her computer and compiles a schedule of payments to be made by EFT to creditors. She obtains this information from the creditors list prepared by Stella Stirling. She carefully checks the details, namely the bank, branch code and account number of the creditor to be paid against a hard copy listing which she keeps for all creditors.
5. Stella Stirling passes the creditors list to Dean Ramjan, as he is solely responsible for the cash payments journal, namely writing it up, posting transactions to the general ledger and reconciling the cash receipts and payments journal to the bank statement monthly.

REQUIRED

Identify the weaknesses in the payments system described by John de Marzo. For each weakness you identify, explain briefly why you consider it to be a weakness (i.e. what can go wrong because of this weakness).

FEEDBACK ON ACTIVITY 4

- 1.1 The invoices received from suppliers are not matched to any other documents, namely the purchase order, supplier delivery note or goods received note. Delmundo (Pty) Ltd could be paying for goods which were never ordered or never received (delivered), and are incorrect in terms of description, quantity or price.
- 2.1 Before the invoice is paid, there is no check to confirm that the purchase is authorised (or even that the goods purchased are of a type used by Delmundo (Pty) Ltd). If nobody checks the above, the risk that employees might be purchasing goods for themselves and have the company pay is significantly increased.
- 2.2 The full amount as reflected on the statement is paid, even where no invoice has been received. Delmundo (Pty) Ltd may be paying for goods incorrectly charged to them.
- 2.3 No checks are carried out on the casts, extensions, calculations and VAT on the purchase invoice. This may result in inaccurate payments and under-recovery of VAT.
- 3.1 No creditors ledger appears to be kept. Creditors are paid on the strength of an external document (creditor statement) only. By having a creditors ledger, a more accurate record of purchases and payments is maintained. The creditors ledger can be reconciled monthly to the creditors statement and any differences and unusual items can be followed up before payment is made.

- 3.2 There is only one cheque signatory. Having only one cheque signatory provides inadequate security over the company's bank balance. As Mary Roosevelt has access to the cheque book and she is the sole signatory, she can write out a cheque to a fictitious creditor at any time.
- 3.3 Mary Roosevelt does not agree the amounts to be paid to creditors to any supporting documentation (for example approved creditors reconciliations). This increases the risk of invalid payments to creditors as Stella Stirling could add a fictitious creditor to the list from which Mary Roosevelt writes out cheques.
- 4.1 There is insufficient control over payments made by EFT. In effect, there is only one "signature" required to access the company's bank account and transfer funds.
- 4.2 EFTs are made without supporting documentation and can be made by Mary Roosevelt at any time and for any amount.
- 4.3 Nobody checks at any stage during the payment whether payments to creditors or others are valid.
- 5.1 No review of the cashbook is carried out by "management", for example the cash book is not reviewed for missing cheque numbers or unusual payments. With no independent review of Dean Ramjan's work, he has the opportunity to cover up misappropriation.
- 5.2 An almost total lack of involvement by senior personnel/management. With such a small staff, and a lack of basic controls, the senior management should be playing an active role – for example, acting as the second signatory on cheques and EFTs or reviewing supporting documentation. This lack of involvement weakens the control environment considerably and facilitates fraud and collusion.

Source: *Graded Questions on Auditing 2015 (Gowar & Jackson 2014:230-231) – adapted.*

Note: The theory relating to this question can be found in Jackson and Stent (2014:11/12–11/13).

To be able to identify weaknesses in any business cycle, you need to know which internal controls should be implemented to mitigate the risks in a perfect control environment.

5.1.4 COMPUTERISATION OF THE CYCLE

Your textbook, Jackson & Stent, describes an integrated manual and computerised acquisitions and payments system of a going concern.

STUDY

Jackson & Stent (2014:11/14–11/30)

ACTIVITY 5

Your textbook describes the application controls over masterfile amendments as mainly **preventative**, but supported by **detective** controls.

1. Explain in your own words why the creditors masterfile is central to the acquisition and payments system.
2. Explain in your own words what the term “preventative” means in this context.
3. Provide an example of a preventative application control.
4. Provide an example of a detective control.
5. Name a few logs and reports that are used as part of detective controls over masterfile amendments.
6. Describe the application controls that should be implemented to prevent and detect errors during amendments made to the creditors masterfile in a computerised environment.

FEEDBACK ON ACTIVITY 5

Reference: Jackson & Stent (2014:11/16-11/18)

1. The accurate and complete processing of authorised purchases and payments depends to a great extent on the integrity of the masterfile. The creditors masterfile will contain information relating to the suppliers of the company, the terms which affect payments, balances and the banking details required to make EFT payments to the creditors.
2. This means that application controls are implemented to **prevent** mistakes from happening in the first place.
3. Restrict write access to the creditors masterfile to a specific member of the section by the use of a user ID and passwords. This will **prevent/deter** unauthorised users from gaining access and making unauthorised amendments to the masterfile.
4. Each logged amendment should be checked to confirm that it is supported by a properly authorised masterfile amendment form (MAF). This will enable management to **detect** any unauthorised amendments to the masterfile.
5. The masterfile amendment log is the main log used when making amendments to the masterfile. Various other logs and reports issued in the course of the acquisitions and payments cycle could be used to detect errors during masterfile amendments, such as the masterfile access violation reports and creditors ledger exception reports, for example invalid account numbers.
6. The application controls that should be present to prevent and detect errors in amending the creditors masterfile in a computerised

environment are described in Jackson & Stent (2014:11/16-11/18) and are not repeated here.

ACTIVITY 6

1. Provide five examples of things that can go wrong when creating a purchase order in a computerised environment.
2. Describe the application controls that should be present to ensure that purchase orders that are **created** and **sent** to suppliers in a **computerised environment** are authorised, accurate and complete.

FEEDBACK ON ACTIVITY 6

Reference: Jackson & Stent (2014:11/20-11/21)

1. Examples of things that could go wrong when creating a purchase order in a computerised environment:
 - Purchase orders could be made out for goods that are not sold by the company if an incorrect inventory item code is entered into the ordering system and the system accepts the inventory code without matching it to inventory codes in the masterfile.
 - Purchases could be made from unapproved suppliers if the system allows the order clerk to enter suppliers that are not approved (no verification checks).
 - Details pertaining to the order could possibly not be entered accurately and completely if the system does not perform programme checks, such as mandatory field checks.
 - An inappropriate quantity of goods could be ordered if the system does not perform programme checks, such as limit or reasonableness checks.
 - Goods ordered could possibly not agree with the purchase requisition report if the order clerk is not alerted by a screen message whenever the quantity of the purchase order does not agree with the purchase requisition report (reasonableness check).
2. The application controls that should be present to ensure that purchase orders that are **created** and **sent** to suppliers in a computerised environment are authorised, accurate and complete are described under points 3 and 4 in Jackson & Stent (2014:11/20-11/21) and are not repeated here.

ACTIVITY 7

1. Your textbook, Jackson & Stent (2014:11/24), explains that electronic funds transfer (EFT) is a fast and efficient method of making payments. Explain why the risk of fraudulent payments is very high if strict controls over EFT are not in place.

2. Describe the application controls that should be present to ensure sound control over the preparation and approval of the schedule of payments in a computerised environment.

FEEDBACK ON ACTIVITY 7

1. Theft of funds from the company's bank account can easily occur because EFTs are quick and efficient. Funds can be transferred to another bank account very quickly, if access can be gained to a company's internet bank account.

Note: Access controls for a company's bank account have been explained in detail in activity 9 of topic 4 and are not repeated here. Refer to topic 4 again if you need to refresh your memory on access controls over a bank account.

2. The application controls that should be present to ensure sound control over the preparation and approval of the schedule of payments in a computerised environment are described under point 3 in Jackson & Stent (2014:11/24-11/26) and are not repeated here.

Remember to limit your answer to the **preparation** and **approval** of the schedule of payments.

CONCLUSION

In this topic, **Acquisitions and Payments cycle**, we explained and applied the activities, functions and documents in the acquisitions and payments business cycle. The risks and internal controls in this cycle were also explained and applied, together with internal control over acquisitions and payments transactions in a computerised environment.

In the next topic we will explain and apply the inventory and production business cycle, together with the applicable internal controls in the cycle.