

ACC531: Auditing and Assurance Services  
Ch8. Acquisition and Expenditure Cycle

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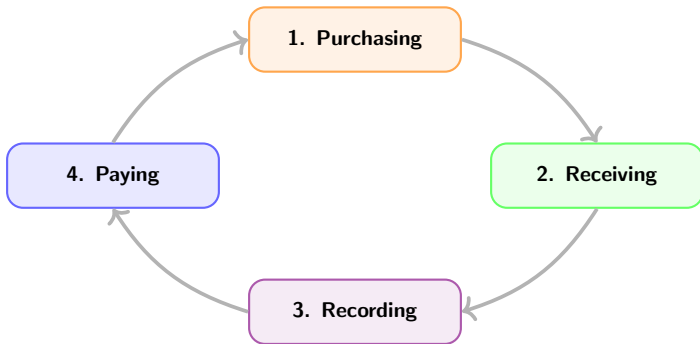
- 1 Acquisition and Expenditure Cycle: Typical Activities
- 2 Significant Accounts and Relevant Assertions
- 3 Risk of Material Misstatement
- 4 Internal Control Activities

### LO 8-1

Describe the acquisition and expenditure cycle, including typical source documents.

# The Acquisition and Expenditure Cycle

- The **acquisition & expenditure cycle** covers all activities from identifying a need for goods or services through payment to the vendor.
- **A/P** and **Expenses** are the most significant accounts.
- Affects **more GL accounts** than any other cycle: A/P, expenses, fixed assets, prepaid, inventory, accrued liabilities.



## Cycle Overview: Four Activities

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#	Activity	Key Risk
1	Purchasing goods/services	Kickbacks <sup>1</sup> & <b>unauthorized</b> vendors
2	Receiving goods/services	Quantity/quality discrepancies
3	Recording A/P and expense	Completeness and <b>cutoff</b>
4	Paying the vendor (Ch6)	<b>Fictitious</b> vendors

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<sup>1</sup>A *kickback* is a secret payment—cash, gifts, or other benefits—that a vendor gives to a company's employee to win the company's business.

## Step 1: Purchasing Goods and Services

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**Phase Goal:** Identify the need and place a valid, authorized order with an approved vendor.

### Key Source Documents

- **Purchase Requisition:** Internal request from department; includes account to be charged and authorization signature.
- **Approved Vendor List:** Only vendors inspected and authorized by the organization; multi-department approval required.
- **Purchase Order (PO):** Formal authorization of the purchase; sent to selected vendor.

### Fraud Risks in Purchasing

- **Kickbacks:** vendor provides gifts/payments to purchasing agent.
- **Shell companies:** fictitious vendors created to collect fraudulent payments.
- **Conflict of interest:** employee holds ownership interest in a supplier.

A **Purchase Requisition** is an **internal** request from a department to the **purchasing** department. It includes the **accounts** to be charged and requires an authorization signature from someone with budget **authority**.

### PURCHASE REQUISITION (Internal)

Requesting Dept: Accounting                      Date: Nov 1, 2026  
Account #: 5200 (Office Supplies)              Req #: REQ-0419

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Description	Est. Unit Price / Qty
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Copy paper, A4	\$35.00 / 10 cases
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Recommended Vendor: Office Depot  
Authorization Signature: J. Smith (Acctg Mgr)

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The **Approved Vendor List** is an **internal** system file of vendors that have been reviewed and authorized by multiple departments (purchasing, quality control, production). Adding a vendor requires multi-department sign-off to prevent **kickback** arrangements.

### APPROVED VENDOR LIST (IT System)

Last Updated: Oct 28, 2026

Maintained by: Purchasing Dept

Vend #	Vendor Name	Status	Approved By
V-044	Office Depot	Active	Purchasing, QC
V-045	Staples Inc.	Active	Purchasing, QC
V-046	PrintCo LLC	Review	Purchasing only
V-047	FastSupply	Inactive	Removed: 2025

A **Purchase Order (PO)** is the formal [authorization](#) of a purchase, sent by the [buyer](#) to the selected [vendor](#). It is the vendor's authority to ship goods and the buyer's commitment to pay.

### PURCHASE ORDER (Sent to Vendor)

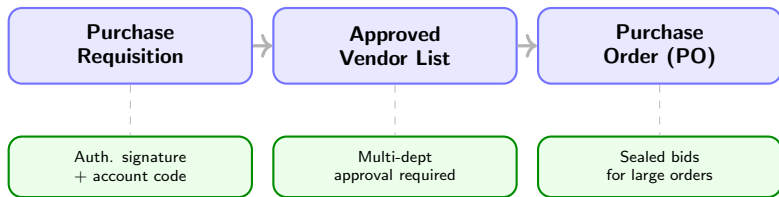
From: Acme Corp  
To: Office Depot  
Ref Req: REQ-0419

PO #: PO-2042  
Date: Nov 2, 2026  
Auth: J. Smith (Purchasing)

Description	Qty	Unit Price	Total
Copy Paper A4 (cases)	10	\$35.00	\$350.00

Payment Terms: Net 30

Deliver by: Nov 5, 2026



- **Price bids**: purchases above threshold require bids from  $\geq 3$  vendors; submitted in sealed envelopes to prevent bid manipulation.
- **Blanket POs**: authorize future deliveries in installments; automatic replenishment systems generate system-level POs.

## Step 2: Receiving Goods or Services

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**Phase Goal:** Verify delivery and document what was actually received.

### Key Source Documents

- **Bill of Lading:** A document from the carrier confirming what was shipped and to whom.
- **Receiving Report:** Prepared by the receiving dept after independent inspection of quantity and quality.

### Key Control: Blind Purchase Order

- A blind PO omits the quantity from the copy given to the receiving department.
- Forces receiving personnel to perform an independent count rather than rubber-stamping the expected quantity.
- Prevents quantity discrepancies from going undetected.

A **Bill of Lading (BOL)** is a document issued by the **carrier** that confirms the goods were picked up from the supplier and identifies the consignee (the receiving company). The receiving department checks that the PO number on the BOL matches before accepting the shipment.

### BILL OF LADING

Shipper: Office Depot      Carrier: FedEx      BOL #: 55821  
Consignee: Acme Corp (Receiving Dock)      Date: Nov 4, 2026  
Ref PO: **PO-2042**

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Description	Pkgs	Weight (lbs)
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Copy Paper A4, cases	10	500
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Carrier Signature: J. Brown (FedEx Driver)

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A **Receiving Report** records the actual quantity and condition of goods received. A **blind** copy intentionally omits the **quantity** from the **PO**, forcing the receiving clerk to perform an independent physical **count**.

### RECEIVING REPORT

Vendor: Office Depot

RR #: RR-1188

Ref PO: PO-2042 (Blind — qty not shown)    Date: Nov 4, 2026

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**Description**

**Qty Received (independent count)**

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Copy Paper A4

**10** of 10 cases

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Condition: **Good**

Inspector: R. Jones (Receiving Dept)

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## Step 3: Recording the Asset/Expense and Liability

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**Phase Goal:** Record A/P correctly in the right period with the right amount.

### Key Source Documents

- **Vendor Invoice:** Bill from the vendor requesting payment.
- **Voucher Package:** PO + Vendor Invoice + Receiving Report + Voucher; A/P records the liability only when all three agree.

### Key Risk: Unrecorded Liabilities

- Goods received but not yet invoiced may go unrecorded, understating A/P and overstating income.
- Automation reduces errors but auditors must evaluate bot controls.

A **Vendor Invoice** is the bill sent by the **vendor** to the **buyer** requesting payment. The A/P department matches it to the **PO** and **receiving** report before recording the liability.

### VENDOR INVOICE

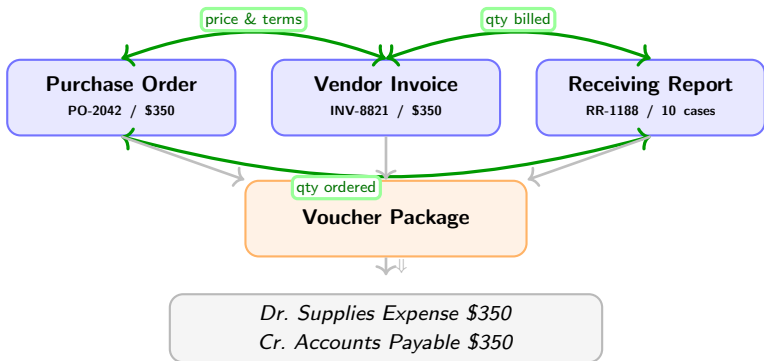
From: Office Depot  
To: Acme Corp  
Ref PO: PO-2042

Invoice #: INV-8821  
Invoice Date: Nov 3, 2026  
Payment Terms: Net 30

Description	Qty	Unit Price	Total
Copy Paper A4 (cases)	10	\$35.00	\$350.00
<b>Amount Due: \$350.00</b>			Due by: Dec 3, 2026

## Document: Voucher Package

The **Voucher Package** combines all three documents into a single package. A/P records the liability only when all three agree (three-way match).



If any document is missing or amounts disagree, the system flags an exception and holds payment.

## Step 4: Paying the Vendor

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**Phase Goal:** Issue payment only for valid, authorized obligations to approved vendors.

### Key Source Documents

- **Voucher Package:** Approved package triggers the payment process.
- **Check / EFT:** Payment instrument prepared by A/P and signed by treasury.

### Key Controls in Payment

- **Separation of duties:** Person who approves the voucher should not sign the check.
- **Cancel documents:** Voucher package stamped *PAID* after payment to prevent duplicate payment.
- Covered in detail in **Ch6** (Cash Disbursements cycle).

- 1 Which document formally authorizes a purchase and is sent to the vendor? C
- A) Purchase requisition
  - B) Receiving report
  - C) Purchase order
  - D) Voucher package
- 2 [T/F] A blind purchase order omits the quantity so receiving personnel must independently count the goods received. T
- 3 [T/F] The approved vendor list is controlled solely by the purchasing department without input from other departments. F

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- 1 Acquisition and Expenditure Cycle: Typical Activities
- 2 Significant Accounts and Relevant Assertions**
- 3 Risk of Material Misstatement
- 4 Internal Control Activities

### LO 8-2

Identify significant accounts and relevant assertions related to the acquisition and expenditure cycle.

- An account is **significant** if there is a reasonable chance it could contain a MM.
- Individuals may also attempt to run **personal expenses** through A/P — validity of expenses is also a risk.
- **Completeness** and **Cutoff** are typically the most significant, relevant assertions for A/P and expenses.

<b>Significant Account</b>	<b>(Key)Relevant Assertions</b>
Accounts Payable	Completeness, Cutoff, Valuation
Various Expenses	Completeness, Cutoff, Accuracy, Classification

- **Completeness**: Are all purchases recorded? Unrecorded A/P understates liabilities and overstates income.
- **Cutoff**: Are liabilities recorded in the correct period? Goods received before period end must be recorded as A/P even if the invoice has not arrived.
- **Valuation**: Is A/P recorded at the correct amount? Total cost must include all components — purchase price, freight, **tariffs**, and **taxes**.

### Other A/P Risks

- **Existence**: Fictitious vendors or A/P already paid but not removed.
- **Duplicate payments**: Same invoice paid twice.
- **Unauthorized items**: Personal expenses routed through A/P.
- Weak **separation of duties** increases embezzlement risk — person approving invoices should not control payments.

## Expenses: Primary Assertions

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- **Completeness**: Are all expenses recorded? Unrecorded expenses understate costs and overstate income.
- **Cutoff**: Are expenses recorded in the correct period? Expenses incurred before period end must be accrued even if not yet invoiced.
- **Accuracy**: Are expenses recorded at the correct amount? Amounts must agree to invoices or work orders.

### Note

- Same direction of risk as A/P — management has incentive to **delay or omit** expense recognition to improve reported results.

- **Classification**: Is the expense recorded in the right account?
- Misclassification can distort **core earnings** even when net income is unchanged — e.g., shifting an operating expense to capex boosts EBITDA without affecting the bottom line.
- For example, WorldCom improperly capitalized expenses to boost EBITDA.<sup>2</sup>

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<sup>2</sup>Capitalizing expenses as assets

→ 1) overstating A, EBITDA, NI, RE; 2) understating E.

- 1 For accounts payable, which assertion is typically the most significant risk in the acquisition and expenditure cycle? **A**
- A)** Completeness
  - B)** Existence
  - C)** Presentation
  - D)** Valuation
- 2 [T/F] Misclassifying an operating expense as a capital expenditure does not change net income and therefore is not an audit concern. **F**
- 3 [T/F] The cutoff assertion for accounts payable requires that liabilities be recorded in the period when goods are received, even if the vendor invoice has not yet arrived. **T**

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## LO 8-3

Discuss the risk of material misstatement in the acquisition and expenditure cycle.

**What Could Go Wrong (WCGW)** in the expenditure and acquisition cycle:

1 **Completeness:** Have all liabilities and expenses/assets been recorded?

2 **Cutoff:** Recorded in the proper period?

3 **Occurrence/Obligation:** Do liabilities reflect actual obligations?

4 **Valuation:** Recorded at the proper amount?

5 **Classification:** Recorded in the proper account?

Assertion	What Could Go Wrong?
Completeness	Liabilities are <b>not</b> recorded.
Cutoff	Liabilities recorded in the <b>incorrect</b> period.
Existence	Liabilities may <b>not</b> represent actual obligations.
Presentation	Liabilities <b>not</b> properly disclosed.
Valuation	Liabilities recorded at an <b>incorrect</b> amount.

Assertion	What Could Go Wrong?
Completeness	<b>Not all</b> expenses are recorded.
Cutoff	Expenses recorded in the incorrect <b>period</b> .
Accuracy	Expenses recorded at an incorrect <b>amount</b> .
Classification	Expenses improperly recorded in the <b>wrong</b> account. <sup>3</sup>

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<sup>3</sup>Classification errors can distort EBITDA and core earnings metrics used by investors without affecting net income.

- A/P is not recorded until the **three-way match** is completed.<sup>4</sup>
- When documents fail to match, recording may be delayed or omitted — **understating** expenses and **overstating** profits.
- MGT may intentionally **delay** expense recording beyond the purchase period to **improve** reported results.
- **Noncancelable purchase commitments**: if market forces cause a permanent decline in value of ordered goods, **losses** must be recognized immediately — even before goods are received.

### Auditor Alert

- Search for **unrecorded liabilities**: inspect receiving reports near period end, review subsequent cash disbursements, and confirm with vendors.

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<sup>4</sup>PO + invoice + receiving report

- 1 A company receives goods on December 30 but does not record the liability until January 5 when the invoice arrives. This failure most directly relates to which assertion? **B**
- A) Existence
  - B) Cutoff
  - C) Valuation
  - D) Classification
- 2 [T/F] Under the WCGW framework, the completeness assertion for A/P addresses the risk that liabilities are recorded in the wrong period. **F**

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### LO 8-4

Identify important internal control activities present in a properly designed system to mitigate the risk of material misstatements for each relevant assertion in the acquisition and expenditure cycle.

- Control activities govern the **nature, timing, and extent** of substantive procedures the auditor will apply.
- Affected accounts beyond A/P and expenses include:
  - ▶ prepaid expenses
  - ▶ fixed assets
  - ▶ inventory
  - ▶ accrued liabilities
  - ▶ supplies
- Four categories of internal control in the expenditure cycle:
  - 1 **Authorization controls**
  - 2 **Separation of duties**
  - 3 **Detailed checking activities** (three-way match)
  - 4 **Periodic reconciliations**

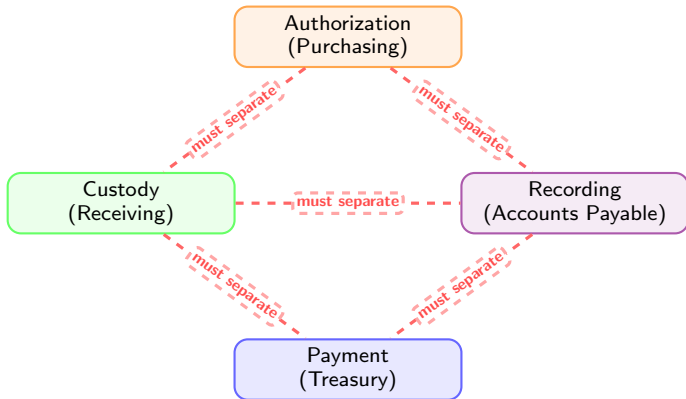
## Proper Authorization for Purchases

- **Approved vendor list:** Only authorized vendors may receive purchase orders; requires multi-department approval to add new vendors.
- **Sealed competitive bids:** Required for purchases above a dollar threshold ( $\geq 3$  bids); bids opened at a publicly announced time.
- **Authorized personnel:** Purchase requisitions and POs may only be initiated by personnel with appropriate **authority** limits.
- **Master file access:** Vendor master file changes **restricted** to authorized persons only.

## Red Flag

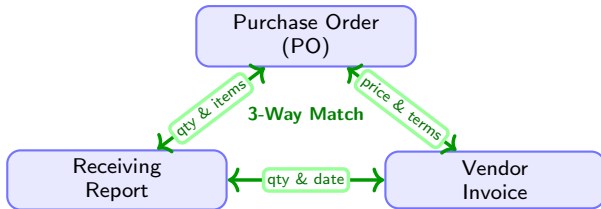
- A single person who can add vendors AND approve purchases creates the opportunity for **kickbacks** and shell company fraud.

# Separation of Duties



**Combining** any two functions opens the door for undetected fraud — e.g., someone who both **authorizes** purchases and **records** them can conceal fictitious transactions.

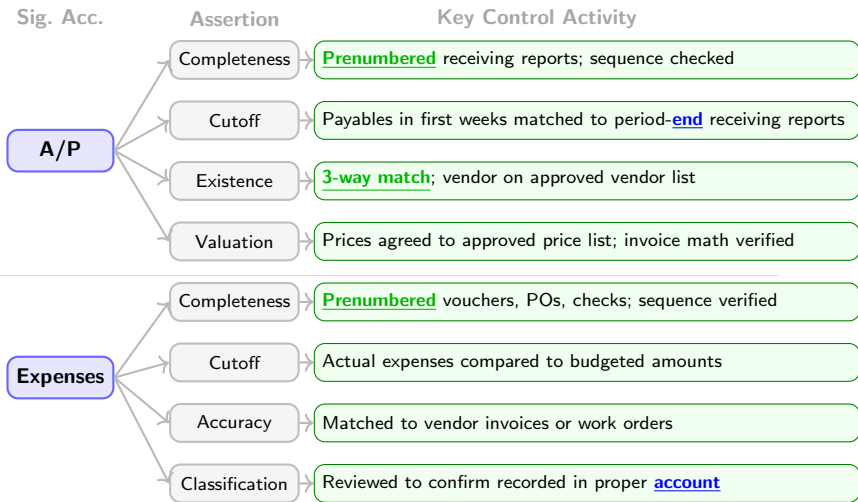
# The Three-Way Match



Mismatches signal a control breakdown: wrong price, **unordered** items, or **unrecorded** receipt.

- System generates **exception** reports: unmatched receiving reports (potential unrecorded liabilities) and unmatched invoices (potential fictitious billing).

# Internal Controls: A/P and Expenses<sup>5</sup>



<sup>5</sup>Based on Louwers Exhibit 8.5.

# Custody and Periodic Reconciliations

## Custody Controls

Physical assets locked; signature required upon receipt

Blank documents (POs, checks) must be secured

Restricted access to vendor master file

## Periodic Reconciliations

A/P trial balance ↔ A/P control account

A/P records ↔ vendors' monthly statements

Unmatched POs, RRs, and invoices reviewed

Physical inventory ↔ inventory records

Fixed asset physical count ↔ asset records

- 1 The three-way match control requires agreement among which three documents? **B**
- A) Requisition, purchase order, and check
  - B) Purchase order, vendor invoice, and receiving report
  - C) Receiving report, check, and voucher
  - D) Approved vendor list, purchase order, and check
- 2 [T/F] A blind purchase order strengthens control over receiving by requiring the receiving department to independently count goods rather than relying on the quantity shown in the PO. **T**
- 3 [T/F] Prenumbering purchase orders helps primarily with the valuation assertion for accounts payable. **F**
- 4 [T/F] Periodic comparison of accounts payable records to vendors' monthly statements is an example of a reconciliation control. **T**

- **Cycle:** Four steps — purchasing, receiving, recording, and payment (Ch6).
- **Key accounts:** A/P (completeness, cutoff, valuation) and Expenses (completeness, cutoff, accuracy, classification).
- **Top risk:** Unrecorded liabilities; classification errors that distort core earnings.
- **Key controls:** Approved vendor list, blind POs, three-way match, separation of duties, and periodic reconciliations.