Accounting Controls Guidebook

Steven M. Bragg

Course #1153298, Version 2004, 12 CPE Credits

Course CPE Information

Course Expiration Date
Per AICPA and NASBA Standards (S9-06), QAS Self-Study courses must include an expiration date that is ***no longer than one year from the date of purchase or enrollment***.

Field of Study
Accounting. Some state boards may count credits under different categories—check with your state board for more information.

Course Level
Overview.

Prerequisites
There are no prerequisites.

Advance Preparation
None.

Course Description
A proper system of accounting controls can mean the difference between a reliable accounting operation that consistently processes business transactions and one that appears to be in a continual state of crisis. In the *Accounting Controls Guidebook*, Steven M. Bragg discusses the overall system of controls, the controls that can be installed for individual accounting processes, and controls for other systems that are peripherally related to accounting operations. You'll learn everything you need to know about all of the major functional areas of a business, including order entry, shipping, billing, cash receipts, accounts payable, payroll, and more.

Publication/Revision Date
April 2020

Instructional Design

This Self-Study course is designed to lead you through a learning process using instructional methods that will help you achieve the stated learning objectives. You will be provided with course objectives and presented with comprehensive information and facts demonstrated in exhibits and/or case studies. Review questions will allow you to check your understanding of the material, and a qualified assessment will test your mastery of the course.

Please familiarize yourself with the following instructional features to ensure your success in achieving the learning objectives.

Course CPE Information

The preceding section, "Course CPE Information," details important information regarding CPE. If you skipped over that section, please go back and review the information now to ensure you are prepared to complete this course successfully.

Table of Contents

The table of contents allows you to quickly navigate to specific sections of the course.

Learning Objectives and Content

Learning objectives clearly define the knowledge, skills, or abilities you will gain by completing the course. Throughout the course content, you will find various instructional methods to help you achieve the learning objectives, such as examples, case studies, charts, diagrams, and explanations. Please pay special attention to these instructional methods, as they will help you achieve the stated learning objectives.

Review Questions

The review questions accompanying this course are designed to assist you in achieving the course learning objectives. The review section is not graded; do not submit it in place of your qualified assessment. While completing the review questions, it may be helpful to study any unfamiliar terms in the glossary in addition to course content. After completing the review questions, proceed to the review question answers and rationales.

Review Question Answers and Rationales

Review question answer choices are accompanied by unique, logical reasoning (rationales) as to why an answer is correct or incorrect. Evaluative feedback to incorrect responses and reinforcement feedback to correct responses are both provided.

Glossary

The glossary defines key terms. Please review the definition of any words you are not familiar with.

Index

The index allows you to quickly locate key terms or concepts as you progress through the instructional material.

Qualified Assessment

Qualified assessments measure (1) the extent to which the learning objectives have been met and (2) that you have gained the knowledge, skills, or abilities clearly defined by the learning objectives for each section of the course. Unless otherwise noted, you are required to earn a minimum score of 70% to pass a course. If you do not pass on your first attempt, please review the learning objectives, instructional materials, and review questions and answers before attempting to retake the qualified assessment to ensure all learning objectives have been successfully completed.
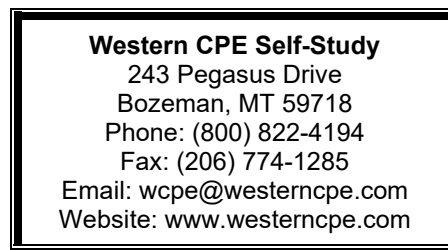
Answer Sheet

Feel free to fill the Answer Sheet out as you go over the course. To enter your answers online, follow these steps:
1. Go to www.westerncpe.com.
2. Log in with your username and password.
3. At the top right side of your screen, hover over "My Account" and click "My CPE."
4. Click on the big orange button that says "View All Courses."
5. Click on the appropriate course title.
6. Click on the blue wording that says "Qualified Assessment."
7. Click on "Attempt assessment now."

Evaluation

Upon successful completion of your online assessment, we ask that you complete an online course evaluation. Your feedback is a vital component in our future course development.

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Chapter 1 – The Accounting Controls Environment

Learning Objectives
After completing this section of the course, you will be able to:
- Recognize situations in which controls can be avoided or must be installed, the nature of the best controls, and areas of concern.

Introduction
Accounting controls are the means by which we gain a reasonable assurance that a business will operate as planned, that its financial results are fairly reported, and that it complies with laws and regulations. They are usually constructed to be an additional set of activities that overlay or are directly integrated into the basic operations of a business.

Unlike most books on accounting controls, we spend little time on the theory and history of controls, and a great deal of time on controls that can be introduced into specific business processes. Thus, this is the *only* chapter in which we will address high-level control issues. In the following sections, we discuss how control systems are usually introduced into a business, how to find the right balance of controls that does not overly burden operations, common fraud risk factors, the main principles to consider when creating a control system, the failings of internal controls, different types of controls, how to implement a controls installation, and the impact on controls of several common business scenarios.

> **Related Podcast Episode:** Episode 135 of the Accounting Best Practices Podcast discusses fine tuning the control system. It is available at: **accountingtools.com/podcasts** or **iTunes**

The Genesis of Accounting Controls
From the perspective of an overburdened management team, accounting controls are simply a form of bureaucracy that interferes with their running of the business; and in a small start-up firm, they may have a point. During the start-up phase, a company is so small that nearly all business transactions are visible to the owners, who may be able to maintain a reasonable degree of control simply because they are deeply involved in every aspect of the business. Adding any type of formal control system at this point is expensive in comparison to the relatively small number of business transactions being processed, so the owners are not thrilled about what they perceive to be a waste of time and money.

However, this situation changes when a company brings in a few employees, since the owners are no longer able to keep direct tabs on operations. At this point, controls are typically added wherever errors arise in the accounting systems. Thus, an inadvertent double payment of an invoice to a supplier will then trigger a set of controls to mitigate the risk of double payments. This is a reactive approach to accounting controls, since the owners are still primarily interested in expanding the business, not in adding "bureaucracy." In short, accounting controls in this stage of a company's life cycle are typically a hodgepodge of controls that were installed in reaction to prior problems.

If a business matures sufficiently, it will encounter an event that will trigger a review of its entire system of controls, probably resulting in an overhaul of the entire system. Examples of those events are:

- *Hire senior accounting management*. The company hires a controller or chief financial officer who has an auditing background, and who therefore has a background in control systems.
- *Engage auditors*. The company is required by an investor or lender to have its financial statements audited, and the auditors generate a considerable amount of advice regarding the inadequacy of the company's control systems.
- *Go public*. If the owners want to take the company public, it must have a strong system of controls, and an annual audit, *and* an audit committee – all of which result in a deep, multi-layered system of controls.

Thus, the system of controls tends to begin with a scattering of controls that were created in response to specific problems, and then becomes more structured over time as a business grows.

The Proper Balance of Control Systems

A person who has been trained in control systems will likely want to install every possible control, and will then feel satisfied that he or she has saved the company from an impending failure. Those on the receiving end of these controls have a different opinion of the situation, which is that controls slow down transactions, require more staff, and have the same general effect on a business as pouring sand into the gas tank of a car.

Because of these radically differing views of the utility of control systems, it is useful to adopt a set of controls that are based on the following points:

- *Risk – monetary*. If a control can prevent a large loss, such as one that could bankrupt a business, then it makes sense to install it, as long as the probability of the event is reasonably high. For example, having two people involved in every wire transfer transaction is a reasonable precaution, given the amount of funds that could be transferred out in a single wire transfer. Conversely, if a control can never save more than a few dollars (such as locking the office supply cabinet), it is entirely likely that the sheer annoyance caused by the control greatly outweighs any possible savings to be achieved from it.
- *Risk – financial statements*. A business must understand its performance, and it can only do so with reliable financial statements. Consequently, controls over recordkeeping should be among the most comprehensive in the company. However, this does not necessarily call for an oppressive amount of controls in those areas where the amounts involved are essentially immaterial to the financial statements.
- *Repetitiveness*. Only install comprehensive controls for those transactions that a business will engage in on a recurring basis. For example, if a company sells equipment to a foreign customer once a year, and wants to hedge the outstanding receivable, a once-a-year transaction does not require an elaborate control system (unless the receivable is for a large amount – see the preceding point about risk). Thus, it behooves a business to concentrate on a finely-tuned set of controls for the 20% of its processes that make up 80% of its business (the Pareto Principle). Of the remaining 80% of the company's

processes, those items involving the most inherent risk should be the prime candidates for strong controls.

- *Offsetting controls*. It may be acceptable to have weak controls in one part of a business, as long as there are offsetting controls elsewhere. For example, it may not be necessary to have someone sign checks, as long as all purchases are initiated with an authorizing purchase order. This concept can be used to great effect if there is a good business reason to keep one business process running as smoothly as possible (i.e., without controls), with offsetting controls in a less noticeable part of the business.

- *Cost*. The cost of controls must be balanced against the expected reduction in risk. This is not a simple calculation to make, for it can be quite difficult to estimate the reduction of risk that will be achieved by implementing a control. One approach to quantifying risk is to multiply the risk percentage by the exposure to the business, which is known as the *expected loss*. See the following example.

  Conversely, it is easy enough to measure the labor cost and other factors required to implement and maintain a control, so there is a tendency for businesses to focus on the up-front cost of a control and downplay the savings that may or may not arise from having the control. The result tends to be a control level that is lower than it should be.

EXAMPLE

High Noon Armaments operates a payroll system that pays employees on a semi-monthly basis. When there are a significant number of data errors in the payroll, High Noon's payroll manager requires that the payroll be run again, at a cost of $5,000.

The payroll manager is considering the installation of an automated data validation software package that is expected to reduce the payroll data error rate from 8% to 1%, at a software rental cost of $250 per payroll. The cost–benefit analysis is:

- *No data validation*. There is an 8% chance of incurring a $5,000 payroll reprocessing cost, which is an expected loss of $400 ($5,000 exposure × 8% risk) per payroll.
- *Data validation*. There is a 1% chance of incurring a $5,000 payroll reprocessing cost, which is an expected loss of $50 ($5,000 exposure × 1% risk) per payroll. There is also a charge of $250 per payroll for the software rental cost.

Thus, there is a reduction of $350 in the expected loss if the control is implemented, against which there is a control cost of $250. This results in a net gain of $100 per payroll by using the control. Changes in the estimated probabilities can have a significant impact on the outcome of this analysis.

The resulting system should be one where some failures will still occur, but either in such small amounts that they do not place the business at risk, or where the probability of occurrence is very low. It is difficult to maintain this balance between controls and operational effectiveness over time, seeing that a growing business is constantly in a state of flux, expanding some lines of business, curtailing others, and installing any number of new systems. It is the job of the controller to watch the interaction of these processes with existing control systems, and know when it is an acceptable risk to pare back some controls, while introducing new ones elsewhere.

It is quite common to see a control system that lags behind the current state of its processes, usually due to inattention by the controller. This means that some controls are so antiquated as to

be essentially meaningless (while still annoying the staff), while new systems are devoid of controls, and will only see new ones when a system failure occurs.

In summary, there is a balance between the system of controls and the efficient operation of a business that is difficult to manage. A good controller will understand the needs of employees to keep operations efficient, and so should be willing to subsist in some areas on control systems that may appear rather skimpy, as long as the tradeoff is between a notable improvement in efficiency and the risk of only modest losses that would have been prevented by controls.

The Nature of Risk

In the last section, we made reference to risk. What is risk, and how does it relate to controls? Risk is the probability that events will vary from expectations. Examples of risk are:
- That competitors will alter the business environment
- That new technology will alter the business environment
- That new legislation will alter the business environment
- That a product failure will lead to a product recall
- That a customer will enter bankruptcy
- That a key raw material will increase in price

Of these sample risks, the first three are caused by external factors and the last three by internal factors. Controls can be used to mitigate internal risks. For example, if there is a risk of product failure, controls can be designed to test the quality of components as they enter the production process, and of finished goods before they are shipped to customers. Similarly, the risk that a customer will enter bankruptcy can be mitigated to some extent by the imposition of strong credit controls.

No matter how thoroughly controls are laced throughout an organization, it is impossible to use them to completely eliminate risk. Instead, there will always be some residual amount of risk that a business must accept. There is usually a tradeoff between imposing a really oppressive system of controls on a business in exchange for a lowered risk level, or a lighter system of controls that makes the business easier to manage, but at the cost of accepting a higher level of risk.

Common Fraud Risk Factors

There are a number of factors that make it more likely that fraud will occur or is occurring in a business. These fraud risk factors include:

Nature of Items
- *Size and value*. If items that can be stolen are of high value in proportion to their size (such as diamonds), it is less risky to remove them from the premises. This a particularly critical item if it is easy for employees to do so.
- *Ease of resale*. If there is a ready market for the resale of stolen goods (such as for most types of consumer electronics), this presents an increased temptation to engage in fraud.
- *Cash*. If there is a large amount of bills and coins on hand, or cash in bank accounts, there is a higher risk of fraud. At a local level, a large balance in a petty cash box presents a considerable temptation.

Nature of Control Environment

- *Separation of duties*. The risk of fraud declines dramatically if multiple employees are involved in different phases of a transaction, since fraud requires the collusion of at least two people. Thus, poorly-defined job descriptions and approval processes present a clear opportunity for fraud.
- *Safeguards*. When assets are physically protected, they are much less likely to be stolen. This can involve fencing around the inventory storage area, a locked bin for maintenance supplies and tools, security guard stations, an employee badge system, and similar solutions.
- *Documentation*. When there is no physical or electronic record of a transaction, employees can be reasonably assured of not being caught, and so are more inclined to engage in fraud. This is also the case if there is documentation, but the records can be easily modified.
- *Time off*. When a business requires its employees to take the full amount of allocated time off, this keeps them from continuing to hide ongoing cases of fraud, and so is a natural deterrent.
- *Related party transactions*. When there are numerous transactions with related parties, it is more likely that purchases and sales will be made at amounts that differ considerably from the market rate.
- *Complexity*. When the nature of a company's business involves very complex transactions, and especially ones involving estimates, it is easier for employees to manipulate the results of these transactions to report better results than is really the case.
- *Dominance*. When a single individual is in a position to dominate the decisions of the management team, and especially when the board of directors is weak, this individual is more likely to engage in unsuitable behavior.
- *Turnover*. When there is a high level of turnover among the management team and among employees in general, the institutional memory regarding how transactions are processed is weakened, resulting in less attention to controls.
- *Auditing*. When there is no internal audit function, it is unlikely that incorrect or inappropriate transactions will be spotted or corrected.

Pressures

- *Level of dissatisfaction*. If the work force is unhappy with the company, they will be more inclined to engage in fraud. Examples of such situations are when a layoff is imminent, benefits have been reduced, bonuses have been eliminated, promotions have been voided, and so forth.
- *Expectations*. When there is pressure from outside investors to report certain financial results, or by management to meet certain performance targets (perhaps to earn bonuses), or to meet balance sheet goals to qualify for debt financing, there is a high risk of financial reporting fraud.
- *Guarantees*. When the owners or members of management have guaranteed company debt, there will be strong pressure to report certain financial results in order to avoid triggering the guarantees.

The presence of fraud risk factors may incline a company to implement a more comprehensive set of accounting controls, to guard against the possibility of fraud.

Control Principles

There are a number of principles to keep in mind when constructing a system of controls for a business. These principles are frequently the difference between a robust control system and one that appears adequate on paper, but which never seems to work in practice. The principles are:

- *Separation of duties*. The separation of duties involves assigning different parts of a process to different people, so that collusion would be required for someone to commit fraud. For example, one person opens the mail and records a list of the checks received, while a different person records them in the accounting system and a third person deposits the checks. By separating these tasks, it is much more difficult for someone to (for example) remove a check from the incoming mail, record a receivables credit in the accounting system to cover his tracks, and cash the check into his own account. Unfortunately, there is a major downside to the separation of duties, which is that shifting tasks among multiple people interferes with the efficiency of a process. Consequently, only use this control principle at the minimum level needed to establish the desired level of control – too much of it is not cost-effective.

- *Process integration*. Controls should be so thoroughly intertwined with business transactions that it is impossible for employees *not* to perform them as part of their daily activities. This level of integration substantially reduces the incidence of errors and the risk of fraud. An example of proper process integration with a control is running all produced items past a fixed bar code scanning station on a conveyor belt, to ensure that all completed goods are recorded. The information is collected without the staff having to do anything. An example of minimal process integration that will likely result in frequent control problems is requiring employees to record this information by hand on a paper form.

- *Management support*. The management team must make it abundantly clear to employees that it thoroughly supports the system of controls. This does not mean that a general statement of ethics is included in the employee manual. Instead, it means that management takes the time to explain controls to employees, is highly visible in investigating control breaches, and takes sufficient remedial action to make it clear to the entire staff that controls are to be taken seriously. Management also does not override its own controls, nor does it set performance standards that are so difficult to attain that employees would be forced to circumvent controls in order to meet the standards.

- *Responsibility*. No control system will work unless people are made responsible for them. This means that someone should be assigned responsibility for every control, and that they receive regular updates on the status of those controls. It would also be useful if the status of their controls are noted in their compensation reviews, and have a direct impact on changes in their pay.

- *Conscientious application*. Employees cannot simply treat controls in a perfunctory manner. Instead, there should be a culture that encourages the close examination of control breaches to determine what went wrong, and how the system can be adjusted to reduce the risk that the same issue will occur again. This level of conscientious behavior must be encouraged by the management team through constant reinforcement of the message that the system of controls is important. It also requires the availability of communication channels through which employees can anonymously report suspected improprieties.

- *Systems knowledge*. It is impossible to expect employees to conscientiously inspect controls unless they already know how systems operate. This calls for the ongoing training of employees to ensure that they thoroughly understand all aspects of the systems with which they are involved. This requires not only an initial training session for new employees, but also reminder sessions that are timed to coincide with any changes in processes and related controls, as well as thorough documentation of the systems. A good level of systems knowledge may call for the use of procedures, training materials, and a core group of trainers.
- *Error reporting*. It is impossible to know if a control is functioning properly unless there is a system in place for reporting control breaches. This may be a report generated by a computer system, but it may also call for open communications channels with employees, customers, and suppliers to solicit any errors that have been found. In this latter case, error reporting is strongly supported by a management group that is clearly interested in spotting errors and correcting them in a way that does not cast blame on those reporting the information. In addition, errors should be communicated all the way up through the organization to the audit committee and board of directors, who can enforce the establishment of enhanced controls.
- *Staffing*. There must be an adequate number of employees on hand to operate controls. Otherwise, there will be great pressure to avoid manual controls, since they take too much time to complete. This is actually a profitability issue, since a business experiencing losses is more likely to cut back on staffing, which in turn impacts the control system.
- *Outlier analysis*. Most businesses create control systems to deal with problems they have seen in the past, or which have been experienced elsewhere in the industry. They rarely create controls designed to mitigate outlier issues – that is, problems that occur very infrequently. The sign of a great control system is one in which employees take the time to examine the control system from a high level, and in light of the current and future business environment, to see if there are any outlier events that present a risk of loss in sufficiently large amounts to warrant the addition of controls. This outlier analysis requires excellent knowledge of the industry and a perceptive view of the direction in which it is headed.

Of the principles just noted, management support is the most crucial. Without it, a system of controls is like a building with no supporting framework – the entire structure crashes to the ground if there is any pressure placed upon it at all. For example, the control system may appear to have proper separation of duties, but this makes no difference if the management team ignores these separations for transactions that it has an interest in ramming through the system.

The Failings of Internal Controls
A well-constructed system of internal controls can certainly be of assistance to a business, but controls suffer from several conceptual failings. They are:
- *Assured profitability*. No control system on the planet can assure a business of earning a profit. Controls may be able to detect or even avoid some losses, but if a business is inherently unprofitable, there is nothing that a control system can do to repair the situation. Profitability is, to a large extent, based on product quality, marketplace positioning, price points, and other factors that are not related to control systems.

- *Fair financial reporting*. A good control system can go a long ways toward the production of financial statements that fairly present the financial results and position of a business, but this is by no means guaranteed. There will always be outlier or low probability events that will evade the best control system, or there may be employees who conspire to evade the control system.
- *Judgment basis*. Manual controls rely upon the judgment of the people operating them. If a person engages in a control activity and makes the wrong judgment call (such as a bad decision to extend credit to a customer), then the control may have functioned but the outcome was still a failure. Thus, controls can fail if the judgment of the people operating them is poor.
- *Determined fraudulent behavior*. Controls are typically designed to catch fraudulent behavior by an individual who is acting alone. They are much less effective when the management team itself overrides controls, or when several employees collude to engage in fraud. In these cases, it is quite possible to skirt completely around the control system.

Thus, the owners, managers, and employees of a business should view its controls not as an absolute failsafe that will protect the business, but rather as something designed to *increase the likelihood* that operational goals will be achieved, its financial reports can be relied upon, and that it is complying with the relevant laws and regulations.

Preventive and Detective Controls
When considering the proper balance of controls that a business needs, also consider the types of controls being installed. A *preventive control* is one that keeps a control breach from occurring. This type of control is highly prized, since it has a direct impact on cost reduction. Another type of control is the *detective control*. This control is useful, but only detects a control breach after it has occurred; thus, its main use is in making management aware of a problem that must be fixed.

A control system needs to have a mix of preventive and detective controls. Even though preventive controls are considered more valuable, they also tend to be more intrusive in the functioning of key business processes. Also, they are installed to address specific control issues that management is already aware of. Management also needs a liberal helping of detective controls, which can be used to spot problems that management was not aware of. Thus, a common occurrence is to throw out a web of detective controls that occasionally haul in a new type of problem, for which management installs a preventive control.

In short, a mix of the two types of controls is needed, where there may be no ideal solution. Instead, there may be a range of possible configurations within which a controls auditor would consider a control system to be effective.

Manual and Automated Controls
If a control is operated by the computer system through which business transactions are recorded, this is considered to be an *automated control*. If a control requires someone to manually perform it, this is considered a *manual control*. Automated controls are always preferred, since it is impossible to avoid them. Conversely, manual controls can be easily avoided, simply by forgetting to enact them. Examples of automated controls are:

- A limit check in a payroll data entry screen that does not allow you to enter more hours in a work week than the total number of hours in a week.
- An address reviewer in the vendor master file that does not allow you to enter an address without the correct zip code.
- An error checker in the inventory database that does not allow an inventory deduction that would otherwise result in a negative inventory balance.

Continuous controls monitoring (CCM) is the use of automated tools to examine business transactions as they occur. A CCM system automatically pulls certain data elements from a database of transactions and reviews all of these data elements. The intent is to conduct a complete scan of the data for control breaches, errors, possible segregation of duties problems, and anomalies from what is expected. The review is conducted by comparing the data to a set of tables that contain permitted transaction authorizations, allowable boundaries for detecting anomalies, itemizations of fields that must be completed for a standard transaction, and so forth. These tables are set up for each major transactional area, such as for inventory, payroll, accounts payable, travel and entertainment, and customer orders.

By comparing the tables to the data, a CCM can spot potential control problems, which are then reported to management on a real-time basis. Here are several examples of CCM tests:
- For the proper authorization of supplier invoices for payment
- For the accuracy of inventory picking transactions
- For the completeness of customer orders
- For the issuance of customer invoices within __ hours of shipments to customers
- For the authorization of credit memos related to unpaid customer invoices

A CCM system is relatively expensive, so this approach to auditing is not typically available to a smaller organization. However, if implemented, the system can reduce the need for manual internal control reviews. In addition, external auditors can rely upon a CCM to some extent when designing their audit procedures, which reduces the cost of their audit. Thus, the net cost of a CCM is somewhat reduced when its full effects are considered.

Several examples of manual controls are:
- Requiring a second signature on a check payment that exceeds a certain amount.
- Requiring the review of the final payroll register by a supervisor.
- Requiring the completion of a monthly bank reconciliation.

The best controls are ones that are preventive (see the preceding section) and automated, since they actively prevent errors from occurring and are very difficult to avoid.

Constructing a System of Controls

The preceding discussion has revolved around the general concept of controls and the principles that should underlie them. But how do you actually create a system of controls? What are the nuts and bolts of building a system? The primary steps are:
1. *Understand the new system.* Work with the systems analysts who have designed the new system to understand what it is designed to do, and each step in the process flow. This may call for the use of flowcharts and walkthroughs of test transactions. The result may

be a formal report describing the system, probably including a preliminary set of procedures.

2. *Explore possible control breaches*. Work with the internal and external auditors, department managers, and systems analysts to estimate where control breaches are most likely to arise in the prospective system.

3. *Quantify possible control breaches*. Estimate the number of occurrences of each type of control breach, the maximum and most likely amounts that a control breach would cost, and their impact on customers and other key company performance metrics.

4. *Design controls*. Based on the quantification of control breaches, design controls that will cost-effectively mitigate risks and be so thoroughly integrated into the underlying process that they will be as robust as possible.

5. *Implement the controls*. Install the controls, along with all necessary documentation, forms, systems, and training, and oversee the initial rollout to ensure that it is operating as planned.

6. *Test the system*. A system of controls does not necessarily operate as planned, perhaps due to a misperception of how the underlying system operates, a bad control design, technology issues, poor employee training, and so on. To detect these issues, test the system of controls by feeding incorrect transactions into it, and see if the controls detect the transactions. If not, adjust the controls and repeat the exercise as many times as necessary.

7. *Conduct a post-implementation review*. All systems change over time, so expect control redundancy and gaps to appear as systems change. Review systems at least once a year, and more frequently if there have been major changes, to see if the existing system of controls should be adjusted. This task may be most easily handled by the internal auditing department, though the controller may want to take on this task instead.

In a larger company, it may be cost-effective to hire a controls analyst who deals with these matters on a full-time basis. In a smaller enterprise, it is more likely that this work will be handled by the controller, who might consider outsourcing it to a consultant.

Special Case – Acquisitions

A particularly burdensome area from the perspective of controls is the acquisition. The controller of the acquiring company is usually responsible for determining the entire system of controls and underlying control principles at the acquired entity, and ensuring that the control environment is brought up to the standards of the acquiring entity as quickly as possible. There are a number of factors to consider in this situation:

- *Outside assistance*. The acquiring entity's accounting staff is fully occupied with integrating the operations of the two businesses, and certainly does not have time to spare for a review of controls. Accordingly, the controller should hire consultants to review the acquiree's control systems and recommend changes. This review should begin as part of the due diligence review prior to the acquisition, and should continue through the subsequent integration process.

- *Principles review*. The fundamental principles outlined earlier in the Control Principles section still apply. This means that the acquiree's control system must be reviewed for separation of duties, process integration, management support, responsibility for controls, systems knowledge, and so on. A particular concern is that the acquirer might want to cut

      costs by reducing headcount at the acquiree, which may impact the principle that there must be adequate staffing to operate the system of controls.

- *Impact of change*. When there are large changes in an organization, as typically happens in an acquiree immediately following an acquisition, there can be equally major morale issues which usually have a negative impact on the system of controls. The controller should be aware of this problem, and expect that there will be more control breaches in the near term as a result of it.

In addition to these concerns, the controller must consider whether a standardized set of controls should be installed throughout all company locations, or if variations will be allowed. If acquisitions are infrequent and the acquirees have business models differing from that of the acquirer, it may be easier to allow local variations on the basic system of control. However, if the parent company is buying a large number of similar businesses, it may make more sense to allow minimal variation, and instead impose the same basic control structure everywhere. The level of standardization has an impact on the variability of procedure documentation and training throughout the enterprise.

Special Case – Employee Turnover

A high level of employee turnover presents a particular problem for the control environment, for controls knowledge weakens with the departure of each successive group of employees. Eventually, employees no longer understand the full breadth of business systems, nor why controls are used. Instead, they are only aware of the particular controls for which they are responsible, and which they were instructed in as part of their abbreviated training. This problem is particularly pernicious when systems and controls are poorly documented, and when those with the most seniority (and presumed knowledge of operations) are the first to leave.

The likely result of a continuing series of employee departures is a gradual decline in the use of manual controls. Also, since employees do not know why controls are being used, they are less likely to be conscientious in pursuing any control breaches found. In addition, business processes will change over time, while controls will no longer change with them. The overall result is a control system that may appear on the surface to be reliable, but which in fact can no longer be relied upon.

The best way to resolve the control problems engendered by high employee turnover is to reduce the turnover. This may involve increased pay rates, improved benefits, less oppressive working conditions, and so forth. Though there is a cost associated with these improvements, they will hopefully be offset by the cost reductions that will occur as the control environment is strengthened.

Special Case – Rapid Growth

When a business grows at a high rate of speed, it encounters the same problems found with a high rate of employee turnover. The problem is that the knowledge of business processes and control systems is centered on the core group of original employees, and must be passed along rapidly to an ever-expanding group of employees. The risk in this situation is that controls knowledge will be so ephemeral among newer employees that the same system of controls

operated by new employees will be substantially less effective than the same system operated by longer-term employees.

The reduced effectiveness of a control system in this environment can be mitigated through the following actions:

- *System replication*. When there is a high rate of growth, there is no way to accommodate local variations on the basic control system, since each one must be separately documented. Instead, management must settle upon one control system, and replicate it throughout the business in a rigid manner. Such a system is much easier to replicate as the business continues to grow.
- *Written procedures*. When there are too many new employees to be properly trained in person, the fallback approach is to construct written procedures that are as thorough as possible. New employees can use these materials to learn more about controls, and they can also be used as training materials.
- *Training*. It is critically important to have a formal training program in a fast growth environment, since new employees can be rotated through it quickly, and they can all be taught exactly the same material. This allows for a considerable amount of uniformity, which is useful for replicating the same control system throughout a company.

> **Tip:** A formal training program only works when the turnover rate among trainers is low. Otherwise, replacement trainers may not be sufficiently knowledgeable about the training materials they are teaching.

- *Employee dispersion*. No matter how well new employees may be trained, they do not yet fully understand why the control system has been constructed in its present form. To lend credence to the current system, it may be necessary to disperse the original group of employees among the various company locations, where they can provide newer employees with a historical perspective on the control system.

Even the recommendations noted here may not be sufficient. If it becomes apparent that the incidence of control breaches is increasing over time, it may be necessary to slow the rate of company growth until the experience level of the employees has increased sufficiently to operate systems in a competent manner. Thus, the level of control difficulties may determine the pace of further expansion.

Control System Documentation

It is difficult to have a formal system of controls without documentation of them. After all, such documents are useful for training new staff, providing consistency in the application of controls, and proving their existence to auditors. However, this does not mean that a company has to hire a consultant to create a superlative set of interlocking documentation for every control in the company. Since controls should accommodate changes in business processes, this means that an elaborate procedures and control manual will probably need to be replaced shortly after it has been issued.

A more efficient view of documentation is to post it on a company intranet site, along with copies of all supporting forms and reports, so that individual pieces can be altered as needed, and users can download what they want.

Also, the level of control documentation should vary by the size of the business. A larger business with many employees and locations may need a detailed level of documentation, because people situated in different locations may be involved in the same process, and do not know how the entire process flows. However, a smaller business where everyone works close together requires far less documentation, since normal interaction between employees makes it relatively easy for them to understand how controls are supposed to work. Thus, an international business may produce an elaborate set of procedure manuals, while a smaller business gets by with a short checklist of controls that are reinforced by discussions among the employees.

Even at the most minimal level, documentation of controls should certainly encompass checklists that can be easily updated and posted in a business. For example, it is essential to close the books consistently every month, so that there is some assurance of having comparable financial statements from month to month. A simple checklist of closing activities can be used, which is a highly effective control over the financial statements.

If there is an audit of a company's financial statements, or if the company is making assertions to regulators about the effectiveness of its system of controls, there will need to be a sufficient level of documentation to support its assertions. This does not mean that the business must produce elaborate documentation, but it should be able to prove that the system of controls was properly designed and that it functions properly. Justifying the design of a system of controls may require something as simple as flowcharts documenting the placement and type of controls, while proof of functionality may require documenting the results of periodic tests of the system.

In summary, the level of documentation used for controls can range from simple checklists to quite elaborate productions, and may be issued electronically or in print. The exact type of documentation used will depend on the nature of the business.

> **Tip:** A smaller business almost certainly does not have the in-house expertise to construct a system of controls. If so, consider retaining a controls consultant who can periodically visit the business and recommend controls based on the structure of its processes and subsequent changes to them.

Terminating Controls

The main focus of this book is to present new controls that can be installed within a company. However, controls tend to slow down the flow of transactions within a business and result in extra costs, and so should only be used when there is a clear need for them. In addition, controls should only be retained for as long as the processes with which they are associated are unchanged. If a process is altered, the linked controls may no longer be needed, but are still retained because no one thought to remove them. The result is likely to be an excessive number of controls and a lower level of process efficiency than should be the case.

Another concern is that too many controls can restrict the ability of employees to take responsibility for their actions. Instead, there is a tendency to adhere to the rules, no matter what, in order to avoid taking responsibility. Eventually, an organization with too many controls becomes hopelessly bureaucratic and calcified, and nearly incapable of enacting any useful changes.

To avoid a burdensome number of controls, it is useful to periodically examine the current system of controls and see if any should be removed. This can be done in the following ways:

- *Review at process change.* Whenever there is a change to a process, incorporate into the process flow analysis a review of all controls built into the process. Doing so may point out that specific controls can be eliminated, or replaced by other controls that are more cost-effective.
- *Review on scheduled date.* Even if there have been no process changes, conduct a comprehensive controls review on a scheduled date, such as once a year. This review may pick up on minor process changes that have been implemented but not formally noted. This approach also allows for consideration of new, more technologically-advanced controls that were not available in previous years.

> **Tip:** Never review a control in isolation from the other controls in a process, since the entire set of controls may provide backup coverage for each other. Deleting one control may weaken a control issue elsewhere in the business process.

No matter which approach is used, it may also make sense to bring in a controls specialist to review existing systems and recommend which controls can be terminated. By doing so, the company gains the benefit of someone who has seen a broad range of controls in many other companies, and who therefore has more experience upon which to base recommendations for changes. The report of this consultant can also be used as justification for changes to the system of controls.

If controls are to be terminated, be sure to discuss the changes thoroughly with the controller and chief financial officer, as well as the company's audit committee. These people may feel that a control should be retained, despite the dictates of efficiency, in order to provide some additional risk reduction. In addition, the termination of controls should be brought to the attention of the company's auditors, who may need to alter their audit procedures to account for the missing controls.

The termination of a control should not be a special event. Instead, it is an ongoing part of the alterations that a company makes as it changes its business processes to meet the demands of the market.

Controls Education

A common scenario in many organizations is that the senior accounting staff decides when to add a control; they do not typically discuss the reason for the control with those people assigned to conduct the business process within which the control is situated. The result is blind obedience to the senior staff's directions, rather than a knowledgeable usage of the assigned control. There can be several unintended and inefficient outcomes of this approach:

- *Bureaucracy.* Employees follow the controls so blindly that they allow no variation from a business process if a control cannot be met. This is a problem when a control is minor, and yet constitutes a major bottleneck in a process flow.
- *Improvements.* If an employee is not informed of the reason for a control, do not expect the employee to make improvement changes to the process that may alter the control.

- *Letter of the law*. When employees do not understand why they are following a control, they are more likely to follow "the letter of the law" and insist on exactly following the procedure they are given. When they encounter a situation that is somewhat different from the established procedure, they do not know how to adapt, and instead will halt the process until they obtain instruction from a supervisor.

When employees leave the company, along with what little background information they may have on existing controls, their replacements will have even less knowledge about why controls are in place, and so will be more likely to engage in the behavior noted in the preceding points.

To avoid these issues with an uninstructed work force, several steps can be taken. Consider the following:

- *Include explanations in procedures*. Include the reasons for controls in the procedural documentation for a process. This has the advantage of transferring knowledge to new hires, even when more experienced employees have left the company.
- *Include in hands-on training*. Conduct controls-specific training for employees. This approach has the advantage of allowing the instructor to emphasize points that are not clear to employees, and generally results in a higher level of knowledge retention.
- *Employ cross-training*. Require employees to cross-train each other, so that knowledge about processes is spread among several employees. This approach should be coupled with the first two points to maximize knowledge transfer.

Ideally, the work force should be sufficiently knowledgeable about the controls they are using that they will understand how each control applies when a specific business transaction varies somewhat from the usual ones that they are accustomed to processing. Ideally in this situation, controls are applied correctly and with minimal input from supervisors.

Structure of this Book

Each of the following chapters addresses a different company process. We describe the controls for each of those processes in the same way, beginning with a general description of the process, explaining those controls most immediately relevant to its day-to-day functioning, and then adding on a cluster of additional controls that might be used to achieve a stronger control environment. The sections included in nearly all chapters are as follows:

1. *Process overview*. This section includes a broad overview of the process for which controls will be described later in the chapter. The section includes both a written description and a flowchart. The flowchart excludes controls, since it is only intended to show the underlying process. A sample flowchart is shown below for the accounts payable function.

Accounts Payable Process Flow

Three-Way Match Paperwork   Evaluated Receipts Paperwork

```
Receiving report
  Supplier invoice
     Purchase order
```

```
Clerk conducts
document matching
as needed
```

```
Purchase order
  Completed goods
  report
```

```
Clerk enters invoice
into accounts
payable system
```

```
Payment is made by
check, direct
deposit, or
procurement card
```
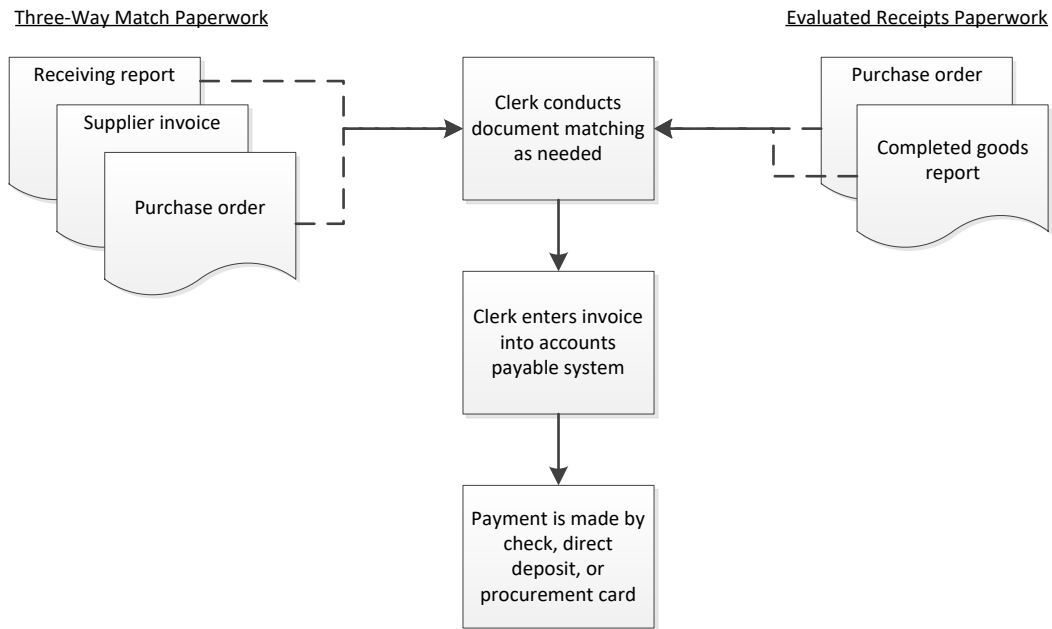
2. *In-process controls*. This section contains only those controls that are usually integrated directly into a process. They are separated into the various work steps of the process in question. For example, the list of in-process controls for accounts payable begin with those controls related to verifying incoming supplier invoices, proceeds to controls for the data entry of those invoices, and ends with the controls associated with paying suppliers.

3. *Alternative control systems*. This section describes the specific in-process controls that should be used for variations on the basic process. For example, the accounts payable function should incorporate certain controls if it is an entirely manual system, and a different set of controls if the process uses an accounting software package. A sample comparison of the controls for these two accounts payable process variations is shown next.

Control Systems for Manual and Computerized Accounts Payable

Manual Controls	Computerized Controls
1. Verify obligation to pay	**1. Verify obligation to pay**
Invoice approval - or	Invoice approval - or
Purchase order approval - or	Purchase order approval - or
Three-way match	Three-way match
Manual duplicate payment search	**2. Data entry**
2. Data entry	Record after approval - or
Record after approval - or	Record prior to approval
Record prior to approval	Use invoice numbering guideline
3. Payment	**3. Payment**
Store checks in locked location	Store checks in locked location
Track check number sequence	Track check number sequence
Require manual check signing	Split check printing and signing
Stamp invoices "paid"	Use positive pay

4. *Additional controls – fraud related*. This section contains additional controls that can assist in detecting or preventing fraud, and which can be added to the core group of in-process controls.
5. *Additional controls – periodic actions*. This section includes any additional controls that might give more support to the core group of in-process controls. Many of these controls can also assist in detecting or preventing fraud.

6. *Additional accounting policies*. This section includes any additional accounting policies that may be relevant to the system of controls, and which were not mentioned earlier in the chapter.

We also include relevant commentary in "Associated Policy" and "Tips" blocks throughout the chapters. The associated policies describe accounting policies that could be imposed to support a particular control, while the tips are concerned with the procedural aspects or usage of a control.

Summary

A key point to take away from this chapter is that there is no boilerplate system of controls that can be inserted into a company. Instead, the control system must be fashioned to meet the risk profile of a business, while accepting minor losses in areas where it is more important to pare back on controls in favor of having more efficient business processes. Consequently, it takes a deep knowledge of a company's processes to set up and continually tweak a system of controls that yields the proper blend of risk aversion and business performance.

The following chapters contain hundreds of controls that could be installed in a business. This does not mean that you *should* install all of them. Instead, review the alternative control systems shown in every chapter to see which mix of controls might work best, given the processes used by your company.

Even if a correct set of controls is installed and they are designed to match the risk profile of a business, this does not mean that they will work properly; excellent control implementation demands a culture of conscientious examination of controls and control breaches by the entire organization. Only through a continuing and company-wide focus on the importance of controls is it possible to have a robust set of controls. Thus, a top-notch control system involves both the controls themselves and the commitment of the organization behind them.

Chapter 1 – Review Questions

The review questions accompanying this course are designed to assist you in achieving the course learning objectives. The review section is not graded; do not submit it in place of your qualified assessment. While completing the review questions, it may be helpful to study any unfamiliar terms in the glossary in addition to course content. After completing the review questions, proceed to the review question answers and rationales.

1.   An event that can trigger a review of the system of controls is:

      a.   Engaging in the annual strategic planning process
      b.   Hiring a general ledger accountant
      c.   Going public
      d.   Engaging in the annual budgeting process

2.   The _____ area should have some of the most comprehensive controls in a company.

      a.   Recordkeeping
      b.   Product development
      c.   Sales and marketing
      d.   Maintenance

Chapter 2 – Order Entry Controls

Learning Objectives
After completing this section of the course, you will be able to:
- Specify the order entry process and examples of controls that can be inserted into the process.

Introduction
Order entry is an area in which customer orders are examined, translated into the format used by a company to process orders, and eventually sent on to other parts of the company for credit checks and fulfillment. In this chapter, we will describe the basic order entry controls, as well as a more comprehensive group of additional controls. We will first address the three main tasks involved in order entry, then describe process-specific controls, and then show the control systems most likely to be needed for the following situations:
- Manual order entry system
- Computerized order entry system

We will then conclude with a discussion of a number of additional order entry controls and related policies.

> **Related Podcast Episodes:** Episodes 1 and 2 of the Accounting Best Practices Podcast discuss order entry controls. They are available at: **accountingtools.com/podcasts** or **iTunes**

Order Entry Process Overview
Order entry involves three primary activities, each of which may require controls, depending on such factors as the size of orders, the timing of payments, and the level of computerization. The core activities are:
1. Verify a customer purchase order
2. Create a sales order
3. Verify credit

A narrative description of these three activities follows.

1. Verify Customer Purchase Order
If orders are large enough, some customers document their orders on purchase orders. The order entry staff reviews the ordering information and purchasing terms stated on each purchase order, and contact the customer if there are problems with the order. This may call for the issuance of a replacement purchase order by the customer.

2. Create Sales Order
If the order entry system is entirely manual, the order entry staff records orders on sales order forms. If the system is computerized, the same information is instead entered in online forms that take the place of sales orders. This information may come from the customer purchase orders noted in the preceding step, or it may be more informally imparted, such as over the phone.

Once the information is transferred to a sales order, the information is checked for accuracy (if it is a manual sales order) or automatically validated (if it is an online form). If manual sales orders are used, copies of the sales orders are distributed as follows:

- Copy to the customer (for verification purposes)
- Copy to the accounting department (for billing purposes)
- Copy to file within the order entry department
- Two copies to the credit department (one to be retained by the credit department and the other copy to be forwarded to the shipping department)

If the sales order is maintained online, none of these copies are used. Instead, electronic notifications are sent to all departments, and the customer typically receives an email notification.

3. Verify Credit

If a company monitors customer credit levels, the order entry staff forwards completed sales orders to the credit department for analysis (see the Credit Controls chapter). However, there are some variations under which the order entry staff handles the credit function. For example, if a customer prepays an order (such as with a credit card), the sales order can be set up by the order entry staff for immediate fulfillment. Similarly, if the order amount is sufficiently small, the order entry staff may be authorized to immediately grant credit and forward the sales order for immediate fulfillment.

The general flow of these three order entry steps, including the associated paperwork, is noted in the following flowchart.

Order Entry Process Flow
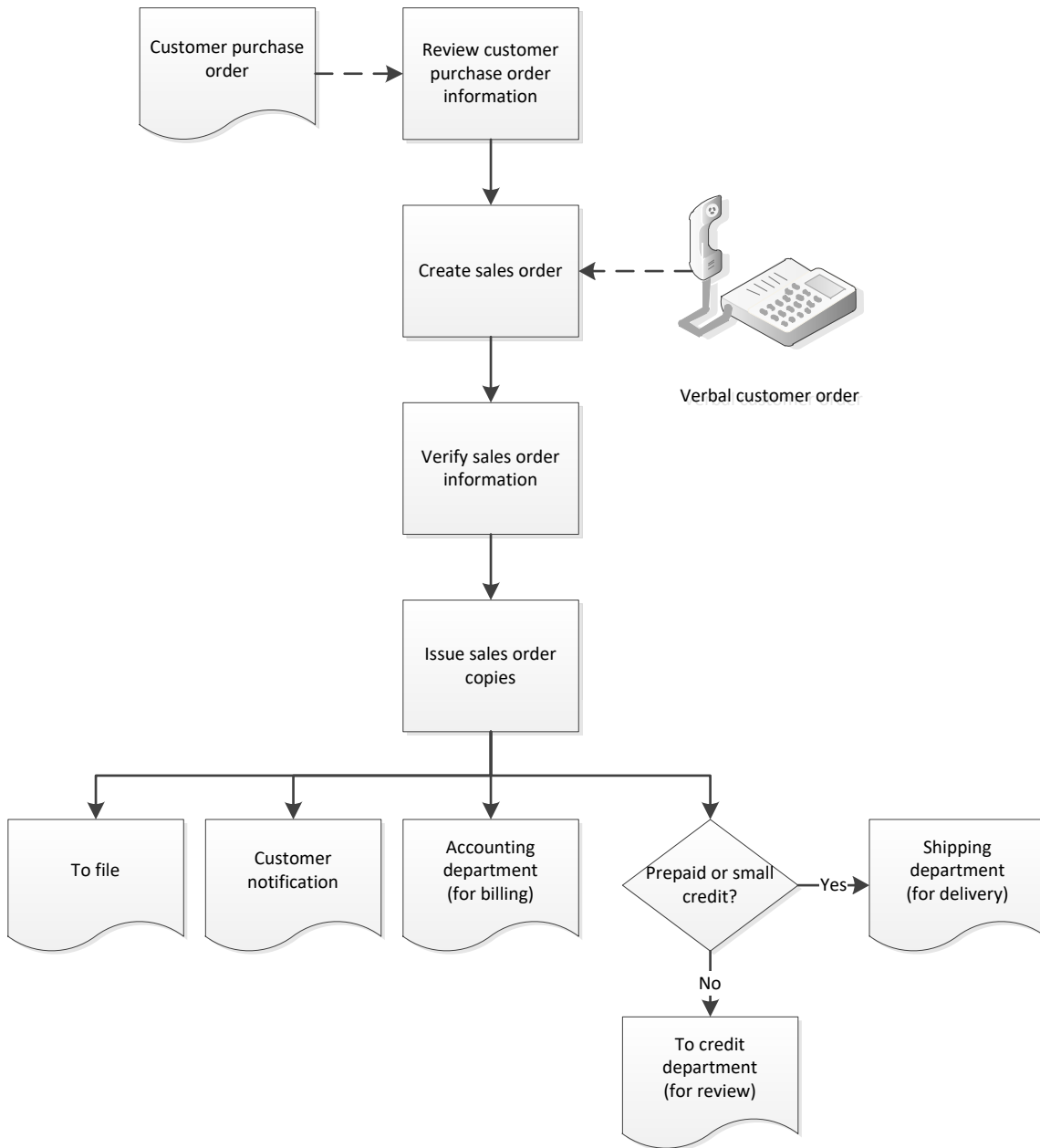
In-Process Order Entry Controls

In this section, we cover the controls that can be imposed on the core order entry processes. In addition, refer to the Additional Order Entry Controls sections for other controls that are positioned outside of the basic order entry transactions.

1. Verify Customer Purchase Order

A customer can submit its own purchase order to the order entry staff. If so, it is very important to verify the information on it, since any later variances between the information on the purchase

order and the company's invoice to the customer will be disputed. The following controls address this issue:

- *Verify purchase order line items*. When a customer sends in a purchase order, the order entry staff verifies the prices, items, quantities and delivery dates stated on the purchase order. Pricing may be a particular problem, especially if a customer has a special pricing deal with the company, so that item in particular should be checked. If items are not currently in stock, verify with the production scheduler that the requested delivery date can be met before accepting the purchase order.

> **Tip:** Verifying purchase order line items can be complicated by the presence of master purchase orders, under which certain customers have special pricing breaks if they commit to buying a minimum quantity of goods each year. The order entry staff should have summarizes of all master purchase agreements on hand, so that they can match prices on the agreements to the purchase order releases received from customers.

- *Legal review of unusual terms*. If a customer insists on terms that depart significantly from those associated with the normal customer order, have the legal staff review the terms. Some terms are related to non-legal factors, such as a different payment schedule or quality criteria, in which case other managers may need to be consulted.
- *Request replacement purchase order*. If any significant terms on the customer purchase order prove to be different from those used by the company, contact the customer and request a replacement purchase order. Otherwise, when the customer eventually receives the company's invoice, it will compare the invoice to its authorizing purchase order and dispute any variances.

> **Tip:** Keep the old purchase order in a tickler file and use it as a reminder to contact the customer for a replacement. When the new purchase order arrives, shred the old version, so it is not mistaken for the new version.

2. Create Sales Order

The order entry staff creates a sales order to translate the orders received from customers into the format used by the company. This information may come from customer purchase orders, or be in a less organized form, such as an order placed over the phone. The key issues are to ensure that the sales orders are filled out correctly, verified, and transmitted back to customers for review. The controls are:

- *Provide staff with a procedure for developing sales terms*. The prices and related terms offered to customers may vary depending on the size of orders and other factors. If so, create a procedure for the staff that clearly states how terms are calculated. This is less necessary for computerized systems where sales terms are automatically inserted, depending on the products and quantities entered.

> **Tip:** It can be quite helpful to develop a training class for the order entry staff to discuss how sales terms can change, depending on what is ordered. This should involve the practice calculation of terms under a variety of scenarios.

- *Review prices*. If the order entry system is not automated, there is a risk that an order entry clerk might enter the wrong price in a customer order. A possible control is to require a mandatory pricing review.

> **Tip:** A mandatory pricing review can add a remarkable amount of extra time to the order entry function, so it may be better to only mandate it for large-dollar orders, or where pricing has recently changed, and the order entry staff is still getting used to the new prices.

- *Review discounts*. If the order entry system is not automated, there is a risk that an order entry clerk might incorrectly calculate a discount, or apply one where it is not justified. If a discount exceeds a certain dollar amount, it may be useful to require approval by a supervisor.

> **Associated Policy:** The review of discounts can be supported by a formal policy, such as: *All discounts of greater than $___ shall be approved by the order entry supervisor before orders are finalized.*

- *Verify inventory*. There is not much use in creating a sales order for goods that the company does not have. Consequently, if there is a manual inventory tracking system, the order entry staff can go to the warehouse and verify that the goods are in stock. In an automated system that is supported by a perpetual inventory system, this control is not necessary.

> **Tip:** If the required inventory on hand is not available and will be on backorder for some time, the order entry staff should contact the customer and see if they want to replace that part of their order with a similar item that is in stock.

- *Verify order details with customer*. When the order entry staff is manually creating an order for a customer, there is an excellent chance that some information will be entered incorrectly. Therefore, the order entry staff should always verify order details with customers.

> **Tip:** When customers place orders through an online Internet form, have the system email them the complete details of the order, so they can review the information. Also, this feedback email should contain a link to the order entry staff, in case customers want to contact a real person to alter their orders.

- *Compare purchase order to sales order*. If the customer has issued a purchase order for goods or services, and the order entry staff copies this information into a sales order, someone should compare the two documents to ensure that the information is the same. This is of particular importance when customers are guaranteed a high level of order accuracy, or when the order entry staff has a history of making mistakes in creating sales orders.

> **Tip:** This examination can be handled as an occasional review by the internal audit department, but only if the number of errors found is so low that conducting an ongoing comparison is not a good use of the order entry staff's time.

- *Use automated validation checks*. Most of the preceding controls are needed where sales orders are compiled manually. If the system is computerized, validation checks can be built into the online form used to create sales orders. These validation checks can automatically review prices, product identifications, quantities on hand, discounts, customer shipping information, and so on.

3. Verify Credit

The order entry staff is not responsible for granting credit to customers, except in situations where the amount granted is so small that the credit department waives the need for a credit review. These options are noted in the following controls:

- *Grant credit for minor orders*. If the credit manager has granted an automatic credit waiver for smaller orders, the order entry staff can stamp a manual sales order as approved, and forward it to the warehouse for immediate fulfillment. In an automated system, the credit waiver level may be built into the software, in which case the sales order is automatically released for immediate fulfillment.
- *Verify credit on larger orders*. If the customer has an account with the company, the order entry staff verifies that there is sufficient credit remaining on the customer's account to accommodate the order. If not, or if the customer is a new one and the order is for a large amount, the order is shifted to the credit department. This is a critical step, since the company is otherwise taking a risk on issuing goods or services on an unwarranted amount of credit.

> **Tip:** While it is the job of the credit department to grant credit to customers, the order entry staff can get started on the paperwork for a new customer by sending them a credit application form as part of the initial contact to discuss an order. This can shorten the overall time required for a customer to place an order and receive delivery.

Alternative Order Entry Control Systems

In this section, we assemble a selection of the controls just described and apply them to different order entry scenarios involving a manual system and a computerized system. While there are certain similarities in the controls used for each system, there are also crucial differences to consider when constructing your own system of controls.

Control System for Manual Order Entry

There is a great deal of manual verification work needed when the order entry function does not involve a computer system. In this situation, any customer purchase orders must be matched against the company price list, reviewed for legal issues, and (in some cases) replacement purchase orders requested. Sales orders must be checked for computational accuracy, as well as the accuracy of pricing, discounts, and the ability of the company to fulfill the order. The resulting sales order is then shared with the customer (who may also review it for accuracy), while a copy is probably also sent to the credit department for approval, depending on the size of the order.

These controls are noted in the following control chart, where controls are clustered under the basic order entry tasks.

Control System for Manual Order Entry

1. Verify customer purchase order

> Verify purchase order line items

> Legal review of unusual terms

> Request replacement purchase order

2. Create sales order

> Review sales order prices and discounts

> Verify inventory

> Verify order details with customer (or purchase order)

3. Verify credit

> Grant credit for minor orders

> Verify credit on larger orders
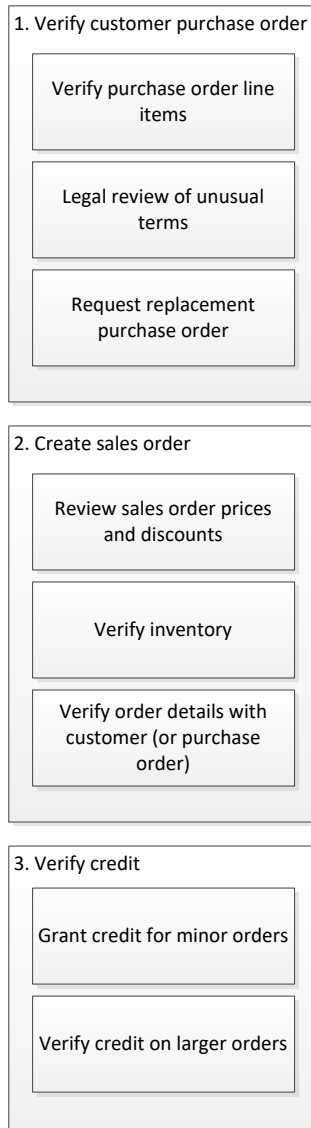
Control System for Computerized Order Entry

When order entry transactions are computerized, it is still necessary to manually review any purchase orders arriving from customers, but much of the sales order review work is now eliminated. Also, the system should automatically route sales orders to the credit department, without any manual transfer by the order entry staff.

These controls are noted in the following control chart, where controls are clustered under the basic order entry tasks.

Control System for Computerized Order Entry

1. Verify customer purchase order

> Verify purchase order line items

> Legal review of unusual terms

> Request replacement purchase order

2. Create sales order

> Use automated validation checks

> Verify order details with customer (or purchase order)

3. Verify credit

> Automatic credit granting for smaller orders

> Automatic forwarding to credit department for larger orders
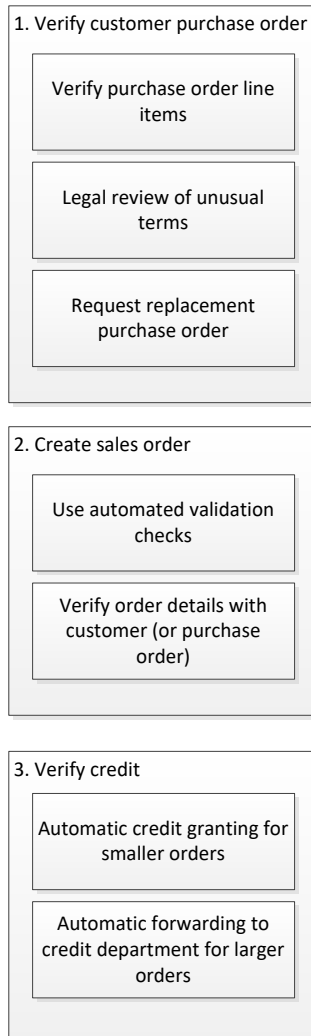
Additional Order Entry Controls – Fraud Related

It is not that common for fraud to arise in the order entry area, though it can be accomplished in small amounts with no-price sales orders, and in larger amounts by inserting fake or altered sales orders into a company's order processing system. The following controls can prevent or at least detect these problems:

- *Password-protect the order entry system*. In a computerized order entry system, always password-protect the system, and require that passwords be changed regularly. By doing so, an unauthorized person cannot access the system and alter the prices that customers are required to pay.
- *Lock up unused sales order forms*. A sales order is essentially an internal authorization to ship goods to a customer. Someone could therefore use it to ship goods to a fake customer. Thus, unused sales order forms should be stored in a locked location. It is particularly important to lock up sales order forms when there is no credit department, since there would then be no credit approval function that would otherwise spot a falsified sales order.

- *Pre-number sales orders*. If customer orders are written down manually, there is some risk that the resulting sales order will be processed more than once, with multiple shipments (and billings) being sent to the customer. Conversely, some sales orders may be lost, which results in lost sales. To avoid this, pre-number all sales orders, thereby uniquely identifying each document.

> **Tip:** This also calls for a system of tracking sales orders that have been processed for shipment, so that the introduction of a duplicate sales order into the system will be immediately flagged.

- *Review no-price sales orders*. Sales orders are occasionally issued with no price listed, usually because marketing samples are being issued. If the quantities on such a sales order are unusually large, it could indicate a fraudulent transfer to a third party.

> **Tip:** It may be possible to require supervisory override in the computer system when creating a no-price sales order.

- *Verify buyer*. If a customer has designated a particular person as its only authorized buyer, it is possible to keep a signature card on file for that person, and verify all incoming customer purchase orders against it. The order entry staff then initials or stamps the purchase order as having been approved. This control is rarely used, and is probably only needed in cases where a company sells high-value items.
- *Review unusual delivery locations*. Someone could pose as a customer and place an order for delivery to a location different from the default address used for that customer. To avoid this, the order entry staff should contact its normal contact person at the customer, using the stored phone number listed in the customer master file, to verify that the order is correct.

> **Tip:** Some computer systems allow for the designation of multiple customer delivery locations in the customer master file. This results in fewer situations where customers are contacted to verify nonstandard delivery locations.

Additional Order Entry Controls – Periodic Actions

The following controls are primarily useful for detecting errors in the sales order system or to squeeze a bit more revenue from sales orders. They are not necessarily part of a specific process; instead, the order entry staff schedules them as separate tasks. These controls are:

- *Review incomplete orders*. Customers may initiate an order but not complete it. This represents potential revenue, so the order entry staff should review all incomplete orders on a daily basis and contact customers to see if the missing information on orders can be completed.
- *Conduct a formal price rollout*. When prices are being changed in a manual order entry system, it can be helpful to engage in a formal rollout of the new prices. This can involve a training session with the order entry staff, distribution of the revised price list, and possibly even having each clerk sign for their receipt of the price list. This approach at least reduces the odds of having incorrect pricing creep into customer orders following a pricing change.

- *Issue price list changes to customers*. To avoid any conflicts between the order entry staff and customers, there should be a procedure for issuing price list revisions to customers. Doing so may avoid any negotiated price reductions in customer orders when customers insist on paying older (and presumably lower) prices.

> **Tip:** Updating the price list should include a procedure to update any prices listed on the company website, probably accompanied by a review by another person to ensure that the prices have been updated correctly.

- *Review master purchase orders*. If certain customers have master purchase order agreements with the company, review the orders from time to time to ensure that the agreements are still valid, and that customers have ordered a sufficient quantity of goods to justify the reduced prices listed in their master purchase orders.

> **Tip:** It is not good for long-term customer relations to wait until a blanket purchase agreement has expired and then contact the customer to point out that they did not buy in sufficient quantities, which calls for a retroactive price increase. Instead, keep customers apprised of their purchasing status throughout the term of their master purchase agreements, so that they are not surprised by any price adjustments imposed at the end of the contract period.

- *Periodically review freight rates*. Most companies conduct regular product pricing reviews, but far fewer examine their freight rates on a regular basis. There should be a procedure for examining the actual freight rates paid to ship goods to customers, versus the prices charged to customers for deliveries. Eventually, these costs and prices will not be properly aligned, and should be revised to ensure that the company does not lose money on freight.

> **Tip:** When reviewing freight rates, be sure to compare the actual costs incurred for overnight deliveries to the amounts charged to customers. Overnight freight companies charge very high rates, which may not be properly reflected in the company's freight rates to customers.

- *Test discounts*. When entering discounts in a computerized order entry system, always test them before rolling out the discounts to customers. An error in the placement of a decimal place can massively increase the amount of a discount.
- *Review discount and coupon termination dates*. Many discounts and coupons are intended to terminate on a certain date. In computerized order entry systems, the failure to set a termination date for these items gives customers the opportunity to continue taking discounts well past the intended date. To avoid this loss of revenues, schedule a regular review of the files containing discount and coupon codes, to ensure that they contain termination dates.
- *Print a discounts-taken report*. If the order entry system is automated, create a report that shows all orders where discounts were taken, and the specific discounts taken. This is useful for seeing if any discounts are still valid that should have been terminated.
- *Audit the pricing file*. In a computerized order entry system, product or service prices may be stored in a single master price file or in the individual product records. In either case, consider auditing this pricing information to ensure that the amount listed on the official price list matches the amount in the computer system.

- *Review reasons for product returns*. When customers return products, see if the reason was that the wrong product was sent to them. If so, go back to the customer's purchase order and the sales order to see if the error occurred in the order entry function. If so, see if there are any procedural or control changes that could prevent the error from arising again.
- *Review the automatic credit granting level*. The order entry staff may be pre-authorized to grant credit to all new customers whose orders are below a certain dollar value. It is useful to periodically compare bad debts to this credit granting cutoff point to see if bad debt levels are unusually high for receivables arising from these automatic grants. The cutoff point may have to be adjusted over time, depending on the general economic environment and the ability of customers to pay.
- *Compare the sales order database to recognized revenue*. If sales orders are computerized and can be linked in the computer system to revenues, create a report that matches recognized revenue to the totals indicated on the related sales orders. This is a good way to see if the company is losing revenue due to cancelled orders, backorders, pricing changes, short shipping, and so forth.

Additional Accounting Policies

There are several supplemental accounting policies that were not mentioned earlier in association with specific order entry controls. These policies are:

- *The business status of new customers shall be investigated if the order amount exceeds $___*. This policy is needed to ascertain whether a new customer might be a fraudulent shell company that has no intention of paying for a shipment, and usually involves buying a credit report from a third-party credit investigation firm. The cutoff level for this policy needs to be set at a level where the cost of the credit report is lower than the profit to be expected from the proposed sale.
- *The sales manager shall maintain an approved price list*. This policy is needed to keep informal prices out of the order entry system. The sales manager should keep an initialed version of each price list as evidence, as well as clearly state the effective revision date on all price lists released to the company.

Summary

The level of control over the order entry function can vary substantially, depending on the timing of payments, the size of orders, and the level of computerization of the process. Thus, an advance payment by a customer eliminates the need for a credit check, while large orders may call for extensive cross-checking of the sales order, and computerization eliminates the need for a great deal of verification work. Thus, you need to be aware of the nature of the business and the company's investment in order entry software before designing a system of controls for it.

Chapter 2 – Review Questions

The review questions accompanying this course are designed to assist you in achieving the course learning objectives. The review section is not graded; do not submit it in place of your qualified assessment. While completing the review questions, it may be helpful to study any unfamiliar terms in the glossary in addition to course content. After completing the review questions, proceed to the review question answers and rationales.

3. It may be necessary to request a replacement purchase order from a customer when:

   a. The company backorders some items
   b. There is a significant difference in the terms used on the purchase order from those used by the company
   c. The company cannot deliver on time
   d. Its credit card payment is rejected

4. An example of a validation check is to:

   a. Verify the authority of the person placing the order
   b. Automatically check quantities on hand
   c. Send a copy of the sales order to the credit department
   d. Separate order taking from cash receipts

Chapter 3 – Credit Controls

Learning Objectives
After completing this section of the course, you will be able to:
- Identify the procedure steps and controls used to process customer requests for credit.

Introduction
Credit management is an area in which a company attempts to ensure that all customer orders being fulfilled on credit are capable of eventually being paid. This requires an order processing flow that forces sales orders through the credit department, where they can be examined for creditworthiness in accordance with various credit rules.

In this chapter, we first address the core tasks involved in the credit function, then describe process-specific controls, and then show the control systems most likely to be needed for the following situations:
- Credit in a manual order processing system
- Credit in a computerized order processing system

We conclude with a discussion of a number of additional order entry controls and related policies.

Related Podcast Episode: Episode 3 of the Accounting Best Practices Podcast discusses credit controls. It is available at: **accountingtools.com/podcasts** or **iTunes**

Credit Process Overview
It is difficult to break down the tasks of the credit department into multiple activities, since there is essentially one overriding task – the granting or withholding of credit. This section contains a narrative description of how a credit department handles this task.

Upon receipt of both copies of a sales order for a *new customer* from the order entry department, the credit staff issues a credit application to the customer. Upon receipt of the completed application, the credit staff conducts its examination of the supplied information, references, credit report, and so forth, and arrives at the amount of credit that it is willing to extend to the customer. If the order processing system is computerized, sales orders generated by the order entry staff will be automatically forwarded to the credit department.

Upon receipt of both copies of a sales order for an *existing customer* from the order entry department, the credit staff determines the amount of unused credit that a customer has, based on its credit limit, unpaid accounts receivable, and orders that have already been approved but not shipped. If there is sufficient credit remaining, it approves the order. If there is not sufficient credit remaining, the staff either considers a one-time increase in the credit level in order to accept the sales order, or contacts the customer to arrange for an alternative payment arrangement. If the order processing system is computerized, the credit staff must load credit limits into the customer master file, after which the system will automatically approve sales orders for which there is sufficient credit remaining.

If the amount of credit granted equals or exceeds the amount of a customer's sales order, the credit staff stamps both copies of the sales order with a credit approval stamp, initials inside the stamp, retains one copy for its files, and forwards the other copy to the shipping department. If the order processing function is computerized, the credit staff instead accesses the sales order in the system and flags it as approved. The system then automatically forwards the sales order to the shipping department.

If the amount of credit granted is insufficient for the size of the sales order, the credit staff contacts the customer and discusses an alternative order situation, such as buying a smaller quantity or paying a portion of the order in cash. This may call for a revision to the sales order; if so, the credit staff appends notes to the sales order and holds it until the customer provides notice of its intentions.

There is an additional scenario outside of the order entry process flow, where the collections staff notifies the credit department when it is having a difficult time collecting overdue accounts receivable. In this situation, the credit staff may take a number of steps, such as cancelling all credit, modifying the credit limit, or placing a hold on any additional customer orders that have not yet been shipped.

The general flow of these credit activities, including the associated paperwork, is noted in the following flowchart.

Credit Process Flow

```
Sales order copy #1
  Sales order copy #2  ----→  Order entry staff     ←----  Sales order
                              forwards sales order          in computer
                              to credit                     system
                              department
                                    |
                                    ↓
                              Issue credit
           ┌------------------ application to
           |                   customer
           ↓
  Credit application
           |
           ↓
           ----------------→  Review credit      ←----  Credit report
                              information and
                              assign credit
                                    |
                                    ↓
                              Update customer
                              master file with
                              credit limit
                                    |
                                    ↓
  Manually stamp      ←-No-  Automated  -Yes→   System
  sales order with           system?            automatically
  approval, or reject it                        accepts/rejects sales
           |                                    order
           ↓                                         |
      Rejected?  -Yes→   Contact the    ←-Yes-  Rejected?
           |             customer                    |
           |                                         |
          No                                        No
           |                  ↑                      |
           └-------→   Forward to the    ←-----------┘
                       shipping
                       department
```

In-Process Credit Controls
In this section, we cover the controls that can be imposed on the core credit activities. In addition, refer to the Additional Credit Controls sections for other controls that are positioned outside of the basic credit process flow.

The main point behind the core group of credit controls is to ensure that a credit review is conducted in those cases where a large amount of credit is involved, and that only approved sales orders are then fulfilled. The following controls address these issues:

- *Require a credit examination for orders from new customers*. When a new customer places an order and requests payment on credit, the order entry staff forwards the resulting sales order (see the Order Entry Controls chapter) to the credit department. The credit department examines the customer's financial information, credit application, and other information, and sets a credit limit for the customer.

> **Associated Policy:** There must be a policy that requires credit approval of orders; this is the reason why the credit department exists. A sample policy is: *The shipping department shall not ship to customers without prior credit approval.*

> **Tip:** It is common for a customer with something to hide to simply not answer a question in a credit application. The credit staff should be particularly cognizant of this missing information, and not be allowed to grant credit without first following up on it.

- *Require a credit examination for orders exceeding credit limits*. When a customer places an order for an amount that exceeds its current unused credit limit, the order entry staff forwards the sales order to the credit department. The credit department should review the customer's payment history and any other information the credit manager believes to be relevant, to see if the order should be accepted.

> **Tip:** From a practical perspective, the credit department does not want to waste time reviewing the credit of existing customers when their orders exceed their credit limits by a small amount. In such cases, the credit manager can grant an automatic one-time credit approval as long as the overage does not exceed a certain percentage of the credit limit.

> **Associated Policy:** A common ploy of the sales staff is to first obtain a large order and then demand that the credit department approve it, since the company will otherwise lose a sale. To mitigate this type of pressure, have a policy that all credit overrides be sent to the credit manager; presumably, the credit manager has sufficient backbone to deal with truculent salespeople. A sample policy is: *All credit overrides shall be approved by the credit manager.*

- *Automatically grant credit for minor orders*. If the credit manager has granted an automatic credit waiver for smaller orders, the order entry staff can stamp a manual sales order as approved, and forward it for immediate fulfillment. In an automated system, the credit waiver level may be built into the software, in which case the sales order is automatically released to the warehouse for immediate fulfillment.
- *Use manual credit granting rules for larger orders*. There is a tendency for the credit staff to be inconsistent in its granting of credit to customers, so they should use a credit decision table to refine who gets credit, and how much those customers are allowed.

- *Use credit rules to grant credit for smaller orders*. Rather than just granting credit automatically for smaller orders, it may be possible to incorporate credit granting rules into the order processing software that does a better job of tailoring credit levels to customers.
- *Stamp sales orders as approved if credit is granted*. A critical control is to stamp sales orders as approved if the credit department finds that a customer has sufficient unused credit for an order. This can take the form of a simple stamp or signature if a company's order processing system is manually operated, or it can be a flag in a sales order record if the process is computerized.

Alternative Credit Control Systems

In this section, we assemble a selection of the controls just described and apply them to the credit management portion of a manual order processing system and a computerized system. The controls for the two systems are largely the same, except for the subsequent handling of sales orders once they are approved.

Control System for Manual Credit Management

In a manual order processing environment, the credit department reviews those sales orders forwarded to it by the order entry staff. This should include the sales orders of new customers, as well as those orders from existing customers that have exceeded their credit limits. The credit staff uses a standard set of credit granting rules to assign credit limits to customers. If the level of credit granted is sufficient for a sales order to be fulfilled by the shipping department, the credit staff stamps its two copies of the sales order, files one copy, and sends the other copy to the shipping department. These controls are noted in the following control chart.

Control System for Manual Credit Management

```
┌─────────────────────────────────────┐
│ 1. Credit management                 │
│  ┌─────────────────────────────────┐ │
│  │   Require credit review for     │ │
│  │        new customers            │ │
│  └─────────────────────────────────┘ │
│  ┌─────────────────────────────────┐ │
│  │    Require credit review for    │ │
│  │  orders exceeding credit limit  │ │
│  └─────────────────────────────────┘ │
│  ┌─────────────────────────────────┐ │
│  │    Use credit granting rules    │ │
│  └─────────────────────────────────┘ │
│  ┌─────────────────────────────────┐ │
│  │     Stamp sales order if        │ │
│  │          approved               │ │
│  └─────────────────────────────────┘ │
└─────────────────────────────────────┘
```
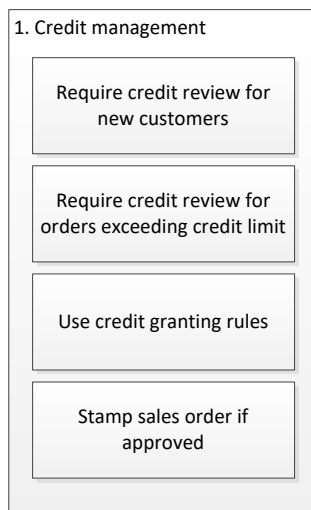
Control System for Computerized Credit Management

The control system for a computerized order processing environment incorporates roughly the same controls as those found in a manual system. The main difference is that the credit staff no longer places an approval stamp on a paper copy of the sales order. Instead, it accesses the sales

order record in the computer system and flags it as having been approved. These controls are noted in the following control chart.

Control System for Computerized Credit Management

1. Credit management
Require credit review for new customers
Require credit review for orders exceeding credit limit
Use credit granting rules
Flag sales order as approved in order processing system
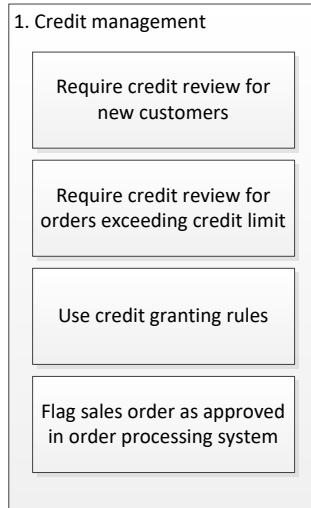
Additional Credit Controls – Fraud Related

There is a strong incentive for someone to fraudulently move a sales order around the credit department, or to falsify a credit limit, since doing so presents the opportunity to deliver goods to a customer who has no intention of paying. Controls that can prevent or at least detect such activity are:

- *Separation of duties*. Anyone who grants credit to customers should not engage in the issuance of invoices. Otherwise, someone could grant an inordinately large amount of credit to a customer who clearly cannot afford it, and then cover up the sale by issuing a credit memo to cancel the receivable.
- *Password-protect the credit management system*. In a computerized credit management system, always password-protect the system, and require that passwords be changed regularly. By doing so, an unauthorized person cannot access the system and alter customer credit levels or give an unwarranted acceptance to a sales order.
- *Lock up the credit approval stamp*. In a manual credit management system, the credit approval stamp is all that someone needs to fraudulently allow a sales order to be fulfilled. Thus, these stamps should be locked up when not in use.

Additional Credit Controls – Periodic Actions

The following controls are primarily useful for maintaining and updating the level of credit assigned to each customer. They are not part of the basic credit granting process; instead, the credit staff schedules them as separate tasks. These controls are:

- *Review the automatic credit granting level*. The order entry staff may be pre-authorized to grant credit to all new customers whose orders are below a certain dollar value. It is useful to periodically compare bad debts to this credit granting cutoff point to see if bad debt levels are unusually high for receivables arising from these automatic grants. The

cutoff point may have to be adjusted over time, depending on the general economic environment and the ability of customers to pay.

- *Periodically review credit levels for all customers*. The credit department approves a certain amount of credit for a new customer based on its financial condition at the time of its initial credit application. However, a customer's financial condition immediately begins to change from that point onward, so it makes sense to periodically review credit levels on a regular basis.

> **Tip:** Given the amount of time involved for an in-depth credit review, it may make more sense to review credit levels most frequently for the largest customers, and at longer intervals for smaller customers.

- *Periodically review credit granting rules*. If there have been changes in the ability of customers to pay their bills in a timely manner, or if management wants to alter sales by loosening or tightening its credit standards, the credit manager will probably need to alter the credit granting rules.

> **Tip:** The review of credit granting rules tends to take place in response to an event, such as an economic downturn, or a corporate strategy planning session, rather than a review that occurs at fixed intervals. Nonetheless, there should be a scheduled review at least once a year, just to ensure that the credit granting rules reasonably reflect the current business environment.

- *Match credit terms to database*. When a company has a computerized order management system, the credit department loads customer credit limits into the customer master file. Someone should periodically compare the written credit limit calculations to the amount listed in the customer master file to ensure that they are the same. It is fairly common for employees to update a credit limit calculation, but not to load it into the computer system.
- *Periodically conduct credit training classes*. Whenever the rules used to grant credit are changed, be sure to conduct a training class with the credit staff to ensure that everyone understands how the new rules are to be used.
- *Audit compliance with credit granting rules*. The credit manager or the internal audit staff should periodically review how the credit staff calculates credit levels for customers, based on the company's credit granting rules. Any unexplained results may be cause for follow-up discussions with the credit staff.
- *Subscribe to a credit score notification service*. Though it can be expensive, consider subscribing to a service that sends an email to the credit department whenever a credit rating service alters its credit score for a customer. This can give early warning of a financial collapse, allowing the credit team to cut back on or eliminate the amount of credit granted.

Additional Accounting Policies

There are several supplemental accounting policies that were not mentioned earlier in association with specific credit controls. The following policies are mostly designed to require credit reviews under a variety of circumstances, as well as to keep from issuing too much credit. The policies are:

- *The business status of new customers shall be investigated if the order amount exceeds $___*. This policy is needed to ascertain whether a new customer might be a fraudulent

shell company that has no intention of paying for a shipment. The policy usually involves buying a credit report from a third-party credit investigation firm. The cutoff level for this policy needs to be set at a level where the cost of the credit report is substantially lower than the profit to be expected from the proposed sale.

- *Customers shall submit a new credit application if they have not ordered from the company in [time period].* This policy is intended to give the credit department a fresh look at the finances of any company with which it does not have a recent order or accounts receivable payment history.

> **Tip:** This policy can be onerous for customers placing small orders, so only apply it for larger orders. Otherwise, some customers will take their business elsewhere.

- *All customer credit limits shall be placed on hold if there have been no customer orders in [period of time].* This policy is similar to the preceding one – to require a new credit review when the company has had no experience with a customer for a fairly long period of time.
- *The credit of all customers issuing not sufficient funds (NSF) checks shall be suspended.* Whenever a customer issues an NSF check, it is very likely that it has little or no remaining cash, and so is a high credit risk. This policy immediately suspends the credit of such customers, and can be used to also put a credit hold on any customer orders already in process within the company and not yet shipped.
- *Report on customers who stop taking early payment discounts.* Some customers consistently take early payment discounts, if the discount is sufficiently tempting. When they stop doing so, it can be a sign that their cash position is worsening. This behavior can be tracked by creating a custom report that shows discounts taken by customer on a trend line.

> **Tip:** A change in early payment discount terms may also trigger a change in the payment behavior of customers. Thus, a reduced early payment discount will result in fewer customers taking advantage of it; this has nothing to do with their financial condition.

- *The sales staff shall obtain prior credit approval for orders expected to exceed $___.* This policy is designed to avoid the common conflict between a sales department that already has a customer order in hand, and a credit department that refuses to allow credit for the order. By engaging in a credit review in advance, the sales staff can be prevented from wasting time on orders that have no hope of being granted credit.

> **Tip:** In reality, obtaining prior credit approval can be quite difficult. There may not be sufficient information about a customer to generate a credit figure, and the sales staff needs to be on sufficiently good terms with the credit department to want to follow this approach. Also, some orders are quite unexpected, so there is no time in which to gain prior approval. Still, this policy is useful as a general guideline.

- *The credit manager must approve all increases in credit of more than __% or $___.* This policy is useful for situations where an unusually large credit increase is about to be enacted. Even if the increase is valid, it ensures that an experienced person looks at the transaction.

Summary

The credit department is, in effect, one very large control, since its entire purpose is to mitigate the risk of not being paid by customers. As such, the department has two key objectives to be concerned with:

- *That sales orders be routed to the credit department*. There should be an iron-clad system to make it as difficult as possible for a sales order to be routed around the credit department.
- *That proper credit granting rules be used*. There should be a reliable methodology for granting credit that will consistently yield the same results, no matter who uses it.

As long as the system of controls of the credit department fulfills these two objectives, a company will have mitigated a significant risk of issuing too much credit to customers.

Chapter 3 – Review Questions

The review questions accompanying this course are designed to assist you in achieving the course learning objectives. The review section is not graded; do not submit it in place of your qualified assessment. While completing the review questions, it may be helpful to study any unfamiliar terms in the glossary in addition to course content. After completing the review questions, proceed to the review question answers and rationales.

5.   The granting of credit to a new customer is typically based on:

   a. A credit application
   b. Whether goods are in stock
   c. Automatic waivers by the computer system
   d. The amount of unused credit

6.   A good way to ensure a credit review is:

   a. Not allowing an invoice to be issued without a credit stamp
   b. Not allowing shipment without a completed pick list attached to the sales order
   c. Not allowing shipments without a credit stamp on the pick list
   d. Not allowing shipments without a credit stamp on the sales order

Chapter 4 – Shipping Controls

Learning Objectives
After completing this section of the course, you will be able to:
- State the controls used to deal with sales orders, drop shipments, back orders, and merchandise returns.

Introduction
We include in the shipping function both the picking of goods from inventory and their subsequent shipment to customers. In this chapter, we will describe the control systems needed to ensure that only authorized sales orders are fulfilled, that the correct items are shipped, and that shipping documentation is forwarded to the accounting department for billing. We will first address the three main tasks involved in shipping, then describe process-specific controls, and then show the control systems most likely to be needed for the following situations:
- Manual shipping system
- Computerized shipping system

We conclude with the discussion of a number of additional shipping controls.

Related Podcast Episode: Episode 10 of the Accounting Best Practices Podcast discusses shipping controls. It is available at: **accountingtools.com/podcasts** or **iTunes**

Shipping Process Overview
Shipping involves three primary activities, each of which may require controls, depending on the level of automation of the order processing function. The activities are:
1. Picking
2. Shipping
3. Forward shipping information

A narrative description of these three activities follows.

1. Picking
Upon receipt of a sales order from the credit department (see the Credit Controls chapter), the shipping manager makes a copy of it and distributes the copy to a warehouse picker. This person picks the goods listed on the sales order and brings them to the shipping area. All items picked are removed from the inventory records.

In an automated system, picking information is routed directly to hand-held computers that direct stock pickers to the locations in the warehouse where items are located, and which they use to relieve items from stock in the inventory records as soon as they are picked. Alternatively, if the computerized system does not send information to hand-held computers, it probably provides for the printing of picking tickets, which are used to pull items from stock.

If some items are not in stock, the shipping staff fills out a backorder form. One copy of the form goes to the order entry staff, which uses it to contact the customer to inform them of the backorder situation. Another copy is kept on file, and a third copy goes to the materials

management staff, who must schedule it to be produced or procured. If the order processing function is computerized, the shipping staff flags the designated items in the sales order record as being on backorder, and the system handles all notifications.

2. Shipping

The shipment of goods to customers begins with the shipping manager printing the latest report from the computer system that identifies which shipments are to be delivered today, based on the required due dates listed on customer purchase orders. If the shipment system is manually operated, the shipping manager compiles this information by perusing all open sales orders for which goods have been picked.

The shipping manager then verifies that items have been picked and are ready for shipment, and contacts freight carriers to schedule pickup times. The shipping staff then prepares bills of lading and packing slips for all deliveries, loads the trucks when they arrive, and completes the shipping log for the day's shipments. In a computerized system, the system prints out all of these documents and updates the shipping log.

3. Forward Shipping Information

Once shipping has been completed, the shipping department sends all shipping documents to the accounting staff, for use in creating customer invoices. If this transfer is manual, a copy of the bill of lading will be sent to accounting, possibly also with a copy of the sales order. If the system is computerized, the system will make this information available to the accounting staff automatically.

The general flow of these three shipping steps, including the associated paperwork, is noted in the following flowchart.

Shipping Process Flow

```
┌──────────────┐          ┌──────────────┐
│              │          │ Receive sales│
│ Sales order  │ ──────▶  │ order from   │
│ copy         │          │ order entry  │
│              │          │ staff        │
└──────────────┘          └──────────────┘
                                  │
                                  ▼
┌──────────────┐          ◇ Automated ◇         ┌──────────────┐
│ Use sales    │ ◀─ No ─  ◇  system?  ◇ ─Yes─▶  │ Print picking│
│ order to pick│          ◇          ◇          │ ticket and   │
│ goods from   │                                │ use to pick  │
│ stock        │                                │ goods from   │
└──────────────┘                                │ stock        │
                                                └──────────────┘
```

Sales order copy ⟶ Receive sales order from order entry staff

Automated system? — No → Use sales order to pick goods from stock

Automated system? — Yes → Print picking ticket and use to pick goods from stock

Items to back order? — Yes → Send backorder notice to order entry and materials management

Items to back order? — No → Verify goods to be shipped

To freight carrier

Packing slip

Bill of lading

Bill of lading copy ◀ Prepare bill of lading, packing slip, shipping log ⟶ Shipping log

Verify goods to be shipped ⟶ Prepare bill of lading, packing slip, shipping log

Prepare bill of lading, packing slip, shipping log ⟶ Forward shipping information to billing clerk

Bill of lading copy ⟶ Forward shipping information to billing clerk

A variation on the shipping process that is less used is to direct sales orders to a supplier, who ships the goods directly to the customer (known as *drop shipping*). This involves the transmission of the sales order to the supplier, which uses it as the basis for a shipment. The supplier then transmits a copy of the bill of lading to the company, which uses it to invoice the customer.

In-Process Shipping Controls

In this section, we cover the controls that can be imposed on the core shipping process. In addition, refer to the Additional Shipping Controls sections for other controls that are positioned outside of the basic shipping transaction.

1. Picking

Though the job of the shipping staff essentially begins with picking products for shipment, the shipping manager must first ensure that the sales orders the department is receiving are valid. The manager must then ensure that the items picked from storage are the ones specified in the sales orders. These controls are:

- *Review for credit approval*. The shipping manager should not process any sales order unless it is either too small to require a credit approval or there is a credit approval stamp on the document. If the order processing system is computerized, there should instead be a credit approval flag on the sales order record.

> **Associated Policy:** There is only one policy that really matters in the shipping department, and that is the prohibition of shipments where there is no credit approval. A sample policy is: *No customer orders shall be shipped without the prior approval of the credit department.*

- *Compare picked items to sales order*. Someone other than the picker can compare the items picked to the sales order or picking ticket, to ensure that they are the same.

2. Shipping

There should be controls to ensure that the correct items are shipped to customers, and that the company is creating the correct documentation for each shipment. These controls are:

- *Compare shipping documents to sales order*. This is the last chance for the company to ensure that what it is shipping to the customer is what the customer ordered. The comparison involves matching the part numbers and quantities on the shipping documents to the sales order.
- *Prenumber shipping documents*. In a manual shipping system, it is important to uniquely identify the shipping document associated with each delivery. Otherwise, there is no evidence that it ever shipped, and there is nothing to trigger the creation of an invoice by the accounting department. Consequently, always prenumber all shipping documents. This control does not apply in a computerized environment, since the computer automatically assigns document numbers.

3. Forward Shipping Information

Following shipment, the shipping manager is responsible for sending a copy of the shipping documents to the billing clerk in the accounting department. This is a crucial step, for unforwarded information means that invoices will not be sent to customers. The following control is used to ensure that shipping documents are forwarded to the billing clerk:

- *Match forwarded information to shipping log*. The billing clerk should periodically compare all shipping documentation received from the shipping department with its shipping log, to verify that all shipping documentation has been delivered to the accounting department. This control is less necessary in a computerized order processing department.

Alternative Shipping Control Systems

In this section, we assemble a selection of the controls just described and apply them to shipping scenarios involving a manual system and a computerized system. While there are certain similarities in the controls used for each system, there are also crucial differences to consider when constructing your own system of controls.

Control System for Manual Shipping

There is a fair amount of paperwork that the shipping manager must monitor in a manual order processing system. The manager should always check incoming sales orders for a credit approval stamp. Also, after items have been picked from stock, they can be compared to the items listed on the sales order. During the process of preparing goods for delivery, the information on the shipping documents can be compared to the picked items on the sales order, to ensure that they are the same. Further, the billing clerk should periodically compare the shipment information forwarded from the shipping department to its shipping log, to ensure that all shipping information was forwarded.

These controls are noted in the following control chart, where controls are clustered under the basic shipping tasks.

Control System for Manual Shipping

1. Picking

> Review for credit approval

> Compare picked items to sales order

2. Shipping

> Compare shipping documents to sales order

3. Forward shipping information

> Match forwarded information to shipping log
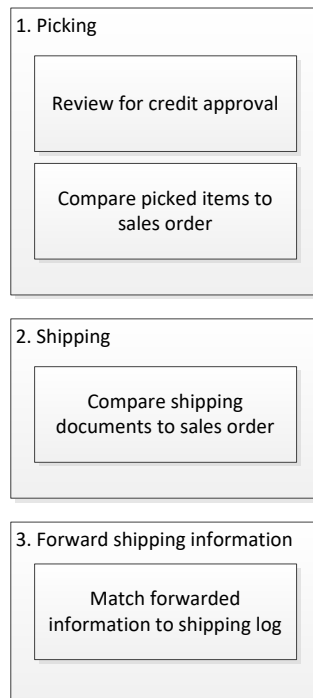
The control system for drop shipping is similar to the controls used for a manual shipping situation, since there are usually not good electronic links between a company and the supplier that is shipping to customers on its behalf.

Control System for Computerized Shipping
The controls for shipping are simplified when there is an automated order processing system. First, there is no longer a need to review documents for credit approvals, since the system will automatically segregate unapproved sales order records. Indeed, the system may so thoroughly block these items from the attention of the shipping manager that he or she may not even be aware of them. Also, there is no longer a need to match information forwarded to the billing clerk to the shipping log, since the system automatically makes this information available to the billing clerk.

These controls are noted in the following control chart, where controls are clustered under the basic shipping tasks.

Control System for Computerized Shipping
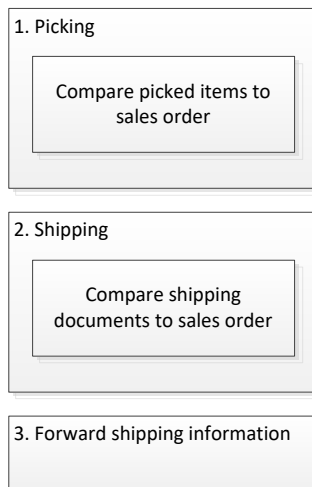
Additional Shipping Controls – Fraud Related
Someone intent on committing fraud may try to fool the shipping manager by forwarding sales orders that have not been approved by the credit department, or by configuring sales orders to have no prices. Further, the shipping manager himself may commit fraud by backdating shipping documents to inflate revenues in a reporting period. The following controls deal with these issues:

- *Return sales orders with no authorization to the credit department*. If a sales order without a credit approval stamp is delivered to the shipping manager, the manager should forward it immediately to the credit manager. This is an excellent way to highlight sales orders that have circumvented the credit approval system.
- *Specify no-price sales orders in shipping log*. Whenever the shipping staff is given a sales order for which there is no price, it should make note of this point in the sales log. If the system is computerized, the system will automatically populate the shipping log with this information. Highlighting no-price items makes it easier for someone to later investigate deliveries for which the company is earning no revenue.

> **Tip:** To make this control more robust, have the shipping manager notify the controller when especially large no-price sales orders are about to be shipped.

- *Maintain an approved order log.* The credit department could maintain a log of all sales orders that it has approved, and periodically compare this document to the sales orders that have shipped. The analysis pinpoints any sales orders that were routed around the credit department.
- *Verify period in which shipment is reported.* The shipping manager may be pressured by management to backdate some shipments into the preceding period, thereby increasing the amount of revenue booked in that period. This issue can be identified by comparing shipping documents from third-party shippers with the dates on which shipments are recorded in the shipping log.
- *Report on early deliveries.* Create a report that identifies deliveries made prior to the delivery date requested by the customer. This may indicate situations where employees are attempting to artificially increase revenues in the short term by issuing goods before customers want them.

Additional Shipping Controls – Periodic Actions

The following controls are mostly intended to spot stray problems in the shipping process that would not necessarily be caught during the daily processing of orders. They are not usually handled as part of daily shipping activities, but rather at longer intervals. The controls are:

- *Review customer complaints.* Management should regularly review the customer complaints database to see if any complaints involve shipping the wrong goods or quantities to customers. If so, this implies that there was a breakdown somewhere in the fulfillment cycle that should be tracked down and corrected.
- *Verify that picked items are noted on sales order.* Someone other than the picker should verify that the items picked have been checked off on the sales order or picking ticket. This is particularly important in a computerized system, where the system will create a backorder transaction for all items not picked.

> **Tip:** Verifying the data entry on every sales order can interfere with the processing of orders, so it may be more efficient to use this control on an occasional basis to see if any stock pickers are unusually bad at recording their picks on sales orders or picking tickets.

- *Conduct a periodic comparison of the products shipped to the items ordered.* The internal audit team or others outside of the fulfillment cycle should occasionally compare the products being shipped to customers to what they ordered, as stated on their purchase orders or the company's sales order that documents what they ordered. This analysis can sometimes spot issues that may call for more detailed investigation, such as backordered items for which there is no expectation of fulfillment.
- *Investigate missing shipping documents.* The shipping department should have a procedure for regularly reviewing the disposition of all shipping documents, based on their document numbers. If a shipping document is not used for whatever reason, mark it as void and record its manner of usage. By maintaining firm control over shipping documents, there is a reduced risk that shipments will not be billed. This control does not apply if the order processing function is computerized.
- *Report on unapproved items appearing in shipping report.* In a computerized order processing system, the daily picking and shipping reports should not show any sales

orders that have not yet been approved by the credit department. If this information appears, the shipping manager should bring it to the attention of the credit manager.

- *Reconcile backordered items*. There should be a continual review of all backordered items to see if the company will be able to ship them in the near future, before customers cancel the ordered items. This can have a significant impact on revenues.

> **Tip:** If it appears that a backordered item will not be available soon, have the order entry staff contact the customer and see if they will accept a substitute product that the company currently has in stock. This earns immediate revenues that would otherwise be problematic.

Summary

The shipping function is a transaction-intensive one, where the shipping staff must be very efficient to pick items from stock and ship them on a timely basis. From a controls perspective, this means keeping unnecessary controls away from the shipping department to the greatest extent possible. The key control points are to ensure that only approved sales orders are fulfilled, and that shipping documentation is reliably forwarded to the billing clerk. The shipping manager is responsible for both of these issues, which should leave the rest of the shipping staff free to fulfill orders.

Chapter 4 – Review Questions

The review questions accompanying this course are designed to assist you in achieving the course learning objectives. The review section is not graded; do not submit it in place of your qualified assessment. While completing the review questions, it may be helpful to study any unfamiliar terms in the glossary in addition to course content. After completing the review questions, proceed to the review question answers and rationales.

7. If an item is not in stock, a copy of the backorder form goes to the:

    a. Accounts payable staff
    b. Billing clerk
    c. Order entry staff
    d. Sales manager

8. The shipping log is useful to the accounting department:

    a. To relieve shipped inventory from the inventory records
    b. To verify that all shipped items were billed
    c. To process payroll for the shipping department
    d. To prove nexus for sales tax purposes

Chapter 5 – Customer Billing Controls

Learning Objectives
After completing this section of the course, you will be able to:
- Cite the controls used in the computerized and manual issuance of invoices to customers.

Introduction
Customer billing is an area in which there can be a great many errors or missing invoices, especially if the invoices are being manually compiled, as is the case for most companies. This can result in greatly delayed payments from customers. In this chapter, we describe the control systems needed to improve the accuracy of invoices and ensure that they are billed as soon as the related goods and services have been delivered. We will first address the four main tasks involved in customer billings, then describe process-specific controls, and then show the control systems most likely to be needed for the following situations:
- Manual customer billing system
- Computerized customer billing system

We conclude with a discussion of a number of additional customer billing controls and related policies.

> **Related Podcast Episode:** Episode 11 of the Accounting Best Practices Podcast discusses billing controls. It is available at: **accountingtools.com/podcasts** or **iTunes**

Customer Billing Process Overview
Customer billing involves four primary activities, each of which may require controls, depending on the circumstances. The activities are:
1. Create invoice
2. Issue invoice
3. Reset for backordered items
4. Accrue revenue

A significant additional activity is the processing of customer credits.

A narrative description of these activities follows.

1. Create Invoice
If the order processing system is a manual one, the billing clerk will first receive a copy of the sales order for a customer's order from the order entry staff, which is stored in a "pending" folder. Then, when the order is shipped, the shipping manager sends a copy of the bill of lading to the billing clerk. The clerk then matches the sales order to the bill of lading, enters the accounting system, and creates an invoice based on the units shipped and prices listed on the bill of lading and sales order, respectively. The invoice may include a charge for freight, which may have been listed on the sales order, or is derived from a standard freight table, or is listed by the shipping manager on the forwarded bill of lading. The invoice may also include a sales tax, which should be automatically added to the invoice based on the sales tax code included in the customer master file for the customer in question. The invoice may also include a reference to

the salesperson who sold the order, which is also included in the customer master file; this information is used to compile salesperson commissions. The clerk then prints the invoice.

In a fully integrated system where the sales order, shipping, and invoicing databases are linked together, the shipping manager will flag a sales order record as having been shipped, at which point it appears in the billing module used by the billing clerk. The system converts this information into an invoice without any data entry. The clerk reviews the information on the invoice for accuracy, and prints it.

2. Issue Invoice
In any computerized billing environment, the billing clerk prints out a copy of the invoice to be filed in the customer file, and prints another copy to send to the customer. If the controller is comfortable with not keeping printed records, only a single invoice is printed, which is sent to the customer.

If the customer wants the company to load the invoice into an online website, the billing clerk must go to that site and make the entry. This may also involve scanning the invoice and uploading it to the website.

3. Reset for Backlogged Items
If a sales order has been completely filled, the billing clerk staples together the copies of the customer invoice, bill of lading, and sales order, and files them in the customer file. If some items on the sales order are on backorder, the clerk makes a copy of the sales order, highlights the unfulfilled items, and puts it back into the pending transactions folder to await further shipping notifications. The copies of the customer invoice, bill of lading, and sales order associated with the first delivery to the customer are stapled together and filed in the customer file.

4. Accrue Revenue
There may be situations at the end of a reporting period where goods have been shipped or services rendered, but the company is not allowed to issue an invoice to the customer. In this case, the billing clerk prepares an accrued revenue authorization for approval by the controller. If approved, the general ledger clerk enters the accrued revenue in the accounting system.

The general flow of the first three of these customer billing steps, including the associated paperwork, is noted in the following flowchart. We do not include the revenue accrual step, since it is not necessarily associated with every billing transaction.

Customer Billing Process Flow

```
┌──────────────┐       ┌──────────────────┐   ┌──────────────────┐      ┌──────────────┐
│ Bill of      │ ····> │ Billing clerk    │   │ Billng clerk     │ <··· │ Sales order  │
│ lading copy  │       │ receives bill of │   │ receives sales   │      │ copy         │
│              │       │ lading copy from │   │ order copy from  │      │              │
│              │       │ shipping manager │   │ order entry      │      │              │
│              │       │                  │   │ staff            │      │              │
└──────────────┘       └──────────────────┘   └──────────────────┘      └──────────────┘
```

Match bill of lading to sales order

Add sales tax if necessary → Create invoice ← Add freight charge if necessary

Enter on customer-designated website ←Yes— Electronic filing? —No→ Send copy to customer

File all document copies ←Yes— Sales order complete? —No→ Retain extra sales order copy for additional billings

Additional Step: Credit Processing

An additional issue that the billing clerk handles is the processing of customer credits. A credit may be issued for a variety of reasons, such as returned goods, a retroactive volume discount, or an invoicing error. If the credit is based on returned goods, the customer normally has to obtain a return merchandise authorization (RMA) from the company. The RMA is needed to keep customers from making spurious returns. If a returned item has an RMA number, the receiving department accepts the return and forwards an RMA notification form to the billing clerk, while sending the returned goods to the warehouse for examination. The clerk then creates a credit transaction for the returned item, less any applicable restocking fee, and sends a copy of the credit to the customer.

Tip: Track the dollar value of RMAs by customer on a trend line. This analysis can spot customers that are abusing the company's return policy, and may lead to their removal as customers.

Customer Credit Process Flow

```
          ┌──────────────────┐
          │ Customer applies for │
          │   RMA number      │
          └──────────────────┘
                  │
                  ▼
          ┌──────────────────┐
          │ Customer service  │
          │   issues RMA      │
          └──────────────────┘
                  │
                  ▼
          ┌──────────────────┐
          │ Customer returns  │
          │ goods with RMA    │
          │   number          │
          └──────────────────┘
```

RMA notification form

Receiving staff forwards RMA notification form to billing clerk

Receiving staff sends returned goods to warehouse for examination

Customer credit

Billing clerk issues credit to customer
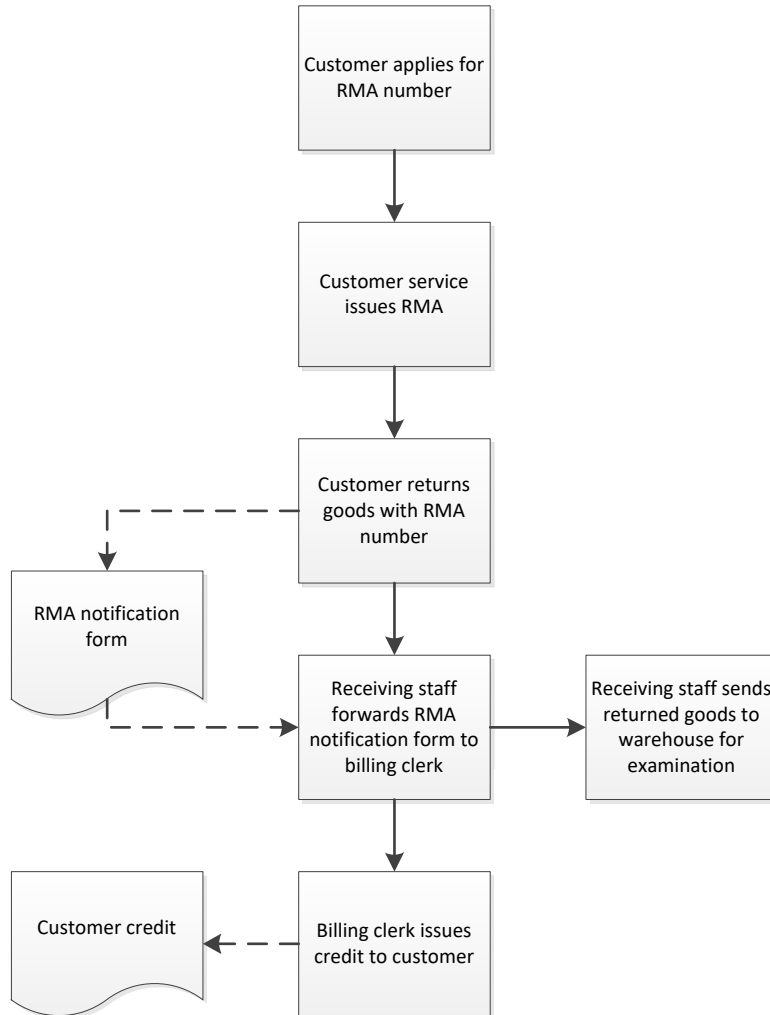
In-Process Customer Billing Controls

In this section, we cover the controls that can be imposed on the core customer billing processes. In addition, refer to the Additional Customer Billing Controls sections for other controls that are positioned outside of the basic customer billing transactions.

1. Create Invoice

If invoices are generated through a fully computerized order processing system, there are few controls needed over the invoice creation process. However, considerably more work is needed to ensure that manually compiled invoices are accurate and include all billable amounts. Most of the following controls deal with the latter situation. The controls are:

- *Confirm discounts and special prices*. If there are discounts or special prices noted on the sales order that are different from the standard price list, it may make sense to confirm them with the sales manager or controller.

> **Tip:** The company should have a standard memo format for issuing notifications to employees about discounts and special prices. The memo should clearly state the beginning and ending dates for these deals.

- *Verify remaining funding level*. If a billing is for a contract that has a fixed amount of total funding, verify the remaining amount of funding available under the contract, and ensure that the invoice total does not exceed the amount of available funding. Otherwise, the invoice will almost certainly be rejected by the customer.

> **Tip:** It is rare for the accounting system to automatically track customer funding levels, so remaining funding will likely have to be independently tracked on a spreadsheet. Since this is a manual record, there is a greater risk that it contains incorrect information, so have someone verify its contents from time to time.

- *Use automatic data validation*. If customer billings are being created in a computerized billing module of the accounting software, include as much automatic data validation in the online form as possible. This can include comparison of prices to a standard price list, address checking, and automated sales tax and freight charge generation.
- *Check the invoice for errors*. Have a second person examine invoices for errors before they are issued. This is important when invoices are quite large, since an error could potentially hold up a large payment.

> **Tip:** It is rarely necessary to cross-check invoices for small-dollar amounts, since it is time-consuming to do so, and any payment delays caused by errors will be small.

2. Issue Invoice

The controls noted here are primarily concerned with the issuance of electronic invoices, because this is frequently handled outside of the normal billing procedure, which increases the risk that they will not be properly forwarded to customers. The controls are:

- *Obtain website confirmation*. Filling out an invoice form on a customer's website can create a problem, because it may not be accepted by the form software. To detect this issue, require the billing clerk to print a copy of the confirmation message from the website, stating that the invoice was accepted, and staple it to the company's copy of the invoice.
- *Require independent verification of electronic filings*. Filing an electronic version of an invoice on a customer's website presents a major control problem, for it is independent of the in-house accounting system, which means that there is no reminder system in place. To ensure that these filings are made, place a reminder on the work calendar of another person, to search through the invoice register at regular intervals for invoices that should have been electronically submitted, and go to the relevant website and verify that they actually were submitted.
- *Include specific website filings on month-end closing checklist*. If there is a checklist that requires someone to verify that electronic invoice filings were made, it is more likely that such filings will be completed. Therefore, include this task on the month-end closing checklist.

- *Review unmatched bills of lading*. At the end of the daily invoice processing, the billing clerk should have no bills of lading for which there is not an associated invoice. If there is an unmatched bill of lading, the clerk should create an invoice for it at once.

3. Reset for Backlogged Items

The control over backlogged items is not critical for the billing clerk, since the primary responsibility for them resides elsewhere in a business. Nonetheless, the following control can be considered in the billing area, just to put in place a reminder that backlogged items are still in process:

- *Compare sales order total to invoice total*. If the total amount of the prospective billing on the sales order does not match the total on the invoice, this tells the billing clerk that there are probably more items to be delivered at a later date, which should trigger the filing of a copy of the sales order in the pending folder, in anticipation of more shipments.

4. Accrue Revenue

The accrual of revenue at the end of an accounting period is not part of the standard generation of customer billings. However, it can have a significant impact on the timing of revenue recognition, and so it should be subject to the following control:

- *Document revenue accruals*. The company's outside auditors will probably review revenue accruals in some detail, so there should be proper documentation of the reason for each accrual.

> **Associated Policy:** It is time-consuming to properly document all revenue accruals, which interferes with the closing process. To conduct a faster closing process, have a policy that establishes the minimum amount above which revenue accruals are allowed. An example is: *A revenue transaction shall not be accrued unless the accrual exceeds $___.*

Additional Step: Credit Processing

The processing of credits is tantamount to handing cash back to customers, and so requires nearly as many controls as the processing of invoices. The following controls are designed to require full justification for the issuance of all larger credit memos:

- *Require return merchandise authorizations*. Any company that sells products should reject returned goods at the receiving dock. Otherwise, customers will return goods for no reason at all, which can result in a substantial financial burden. To place more control over the process, require customers to request a return merchandise authorization (RMA) from the order entry staff, which requires them to explain why they are returning the goods.

> **Tip:** An RMA is a virtual necessity when a company is dealing with retailers and wholesalers, since they will simply box up all unsold items and ship them back to the company.

- *Initiate credit memo upon receipt of RMA notification form*. The billing clerk only issues a credit for a returned item when an RMA notification form arrives from the receiving dock. Further, the billing clerk should staple a copy of the notification to a copy of the credit memo, which provides proof that the credit was only issued after the product return was completed.

> **Tip:** This control does not work when a product might have been so damaged in transit to a customer that there is no point in returning it. If so, the controller or credit manager should approve the issuance of a credit in the absence of an RMA notification.

- *Management approves credits.* If credits are being granted for items other than returned goods, the credit manager or controller should approve the credits in advance. Otherwise, there could be a situation where employees collude to take incoming cash from customers and cover their tracks by issuing offsetting credits to those customers.

> **Tip:** It is impractical to require supervisory approval for every credit created, since many are for small cleanup issues, such as eliminating a residual $0.01 balance in an account. Consequently, only impose this control for larger credits.

Alternative Customer Billing Control Systems

In this section, we assemble a selection of the controls just described and apply them to customer billing scenarios involving a manual system and a computerized system. While there are many similarities in the controls used for each system, there are also crucial differences to consider when constructing your own system of controls.

Control System for Manual Customer Billings

When the billing clerk is creating invoices "from scratch," either in the accounting software or by hand, it is essential to verify any special pricing or discounts noted on the sales order, as well as to verify any remaining funding that the customer has available to pay the invoice. Also, it is nearly mandatory to have a second person check invoices for errors when invoice amounts are quite large, since customers will delay payment if there are invoicing errors.

Once invoices have been created, the billing clerk should verify that there are no remaining bills of lading for which no invoices have been issued. Also, if the customer requires that invoices be submitted in an electronic format, the billing clerk should obtain a receipt from the online form and attach it to the company's copy of the invoice. Finally, the clerk should create a copy of the sales order if some items were not shipped and put the copy back in the pending folder, which provides notice that additional shipments will be billed at a later date.

These controls are noted in the following control chart, where controls are clustered under the basic customer billing tasks.

Control System for Manual Customer Billings

1. Create invoice

> Confirm discounts and special prices

> Verify remaining funding

> Check invoice for errors

2. Issue invoice

> Review unmatched bills of lading

> Obtain website confirmation for electronic filings

3. Reset for backlogged items

> Compare sales order total to invoice total
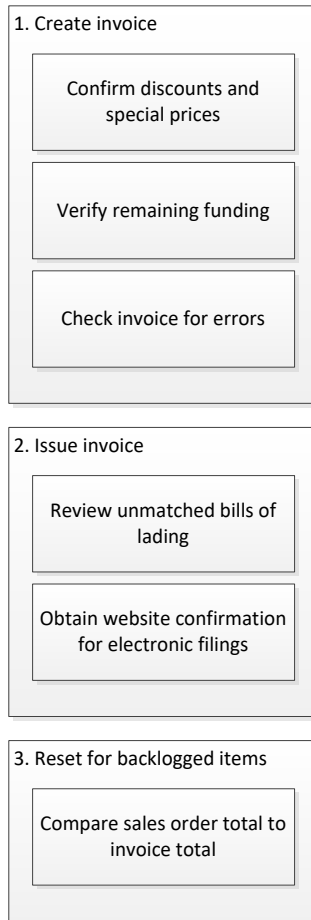
Control System for Computerized Customer Billings

If a computer system encompasses the entire flow of transactions through the order processing cycle and into the billing module of the accounting software, some controls can be reduced or eliminated. However, we still recommend that the billing clerk confirm discounts, special pricing, and remaining customer funding, since this information may have originally been entered into the system in error. Also, irrespective of the level of computerization, someone should still review larger invoices for errors before the invoices are issued.

It is not necessary for the billing clerk to search for any unbilled bills of lading, since the computer system should automatically bring these deliveries to the attention of the clerk. There is also no need to keep a separate copy of the sales order in a pending file if some items are on back order, since this information is stored in the computer system.

These controls are noted in the following control chart, where controls are clustered under the basic customer billing tasks.

Control System for Computerized Customer Billings

```
┌─────────────────────────────────────┐
│ 1. Create invoice                    │
│   ┌───────────────────────────────┐  │
│   │ Confirm discounts and         │  │
│   │ special prices                │  │
│   └───────────────────────────────┘  │
│   ┌───────────────────────────────┐  │
│   │ Verify remaining funding      │  │
│   └───────────────────────────────┘  │
│   ┌───────────────────────────────┐  │
│   │ Use automatic data            │  │
│   │ validation                    │  │
│   └───────────────────────────────┘  │
│   ┌───────────────────────────────┐  │
│   │ Check invoice for errors      │  │
│   └───────────────────────────────┘  │
└─────────────────────────────────────┘

┌─────────────────────────────────────┐
│ 2. Issue invoice                     │
│   ┌───────────────────────────────┐  │
│   │ Obtain website confirmation   │  │
│   │ for electronic filings        │  │
│   └───────────────────────────────┘  │
└─────────────────────────────────────┘

┌─────────────────────────────────────┐
│ 3. Reset for backlogged items        │
└─────────────────────────────────────┘
```
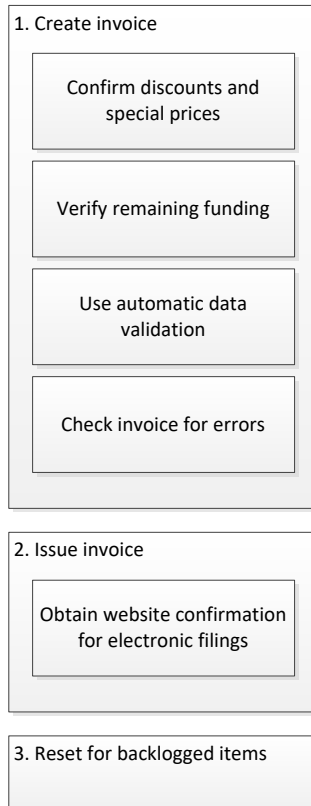
Additional Customer Billing Controls – Fraud Related

The customer billings area can be used to commit fraud by altering invoices and issuing credit memos to hide the theft of cash receipts, or to hide the delivery of goods to fake customers. The following controls can prevent or at least detect these issues:

- *Separation of duties*. The billing clerk should not be able to apply cash receipts from customers to the accounts receivable records. Otherwise, the billing clerk could pocket incoming cash and alter the accounts receivable records to hide the receipt.
- *Verify shipping date*. Management may pressure the shipping manager into recording shipments as having occurred in the preceding accounting period, thereby inflating revenue in the preceding period. This can be detected by comparing copies of the bill of lading to the shipping log. However, a continuing control weakness is that management may pressure the accounting department into also engaging in the same trickery.

> **Tip:** If shipping documents are prenumbered, it is a reasonable assumption that all shipping documents used after the first one stating that it was for a shipment in the next reporting period were also in the next reporting period.

- *Review cash receipts*. The billing clerk can commit fraud by increasing the prices on an invoice above those stated on the sales order, issuing a replacement invoice for the company's records at the correct prices, and sending the incorrect invoice to the customer. Then, upon payment by the customer, the billing clerk or a person working

with the billing clerk pockets the difference and only records the expected amount of the receipt. To detect this type of fraud, the internal audit staff should periodically compare the amounts shown on the images of checks received (usually posted on the bank's website) to the amounts listed as having been paid in the accounting system.

- *Review credits on a trend line*. The credit manager or controller should periodically run a report that shows the dollar total of credits issued to each customer, by month, on a trend line. This information is useful for spotting unusually large credit amounts that may indicate unauthorized activity.
- *Audit revenue recognition*. Have the internal audit staff periodically review how well revenue recognition was handled in relation to a selection of revenue-generating activities. This may result in adjustments to the procedures the billing clerk uses to record customer billings.

Additional Customer Billing Controls – Periodic Actions

The following controls are primarily useful for ensuring that customer billings are issued for all shipments made to customers. They also deal with billing errors, the timing of revenue recognition, sales tax inclusions, and the processing of credit memos. They are not necessarily part of a specific process; instead, the customer billing staff schedules them as separate tasks. These controls are:

- *Investigate pending sales orders*. The order entry staff typically sends a copy of each sales order to the billing clerk, who files it until such time as the related shipping information arrives from the shipping department. If sales orders remain unmatched for a certain period of time, the billing clerk should investigate the status of those orders.

> **Tip:** If a customer later cancels a sales order, the order entry staff should forward a copy of the cancelled order to the billing clerk, so that the clerk can match it to the related pending sales order and remove it from the pending folder.

- *Match forwarded information to shipping log*. The billing clerk should periodically compare all shipping documentation received from the shipping department with its shipping log, to verify that all shipping documentation has been delivered to the accounting department. This control is less necessary in a computerized order processing environment.
- *Match sales orders to invoices*. Periodically run a report that lists all filled sales orders, and compare it to invoices issued to customers. There should be an investigation of any filled sales orders for which no corresponding invoice can be found.

> **Tip:** It is possible that there will be no match between a sales order and an invoice, because there are multiple customer records for the same customer, and the invoice was issued under a different one than was used for the sales order. This can be remedied by regularly consolidating duplicate customer records in the customer master file.

- *Review customer complaints*. Accumulate all customer complaints into a complaints log, and review it regularly to see if any complaints relate to billing errors.
- *Instruct the billing clerk regarding cutoff timing*. It may be useful for the controller to notify the billing clerk of the need for a proper month-end cutoff at the end of each accounting period.

- *Compare sales to forecast.* If a company maintains a short-term revenue forecast, actual sales should be fairly close to it. If there is a significant difference between the actual and forecasted numbers, this may call for additional investigation.
- *Issue statements.* A possible control is to issue a statement to all customers, noting the payment status of all outstanding invoices. If customers call back to ask for invoice copies, it is possible that the company did not mail the invoices, or sent them to the wrong address. Consequently, always follow up on customer inquiries stemming from statements of account.

> **Tip:** The contact information listed on statements should direct customers to someone other than the billing clerk. If the billing clerk is engaged in fraud, it hardly helps to route customer inquiries straight back to that person. Better options for the contact person are the controller or an assistant controller.

- *Reconcile aging to general ledger.* At the end of each month, the billing clerk should reconcile any differences between the total balance in the trade accounts receivable general ledger account and the aged accounts receivable report. Ideally, the two balances should match, but journal entries may have been added to the general ledger account, such as for revenue accruals, that will cause a difference.

> **Tip:** It may make sense to keep all journal entries away from the trade accounts receivable account, and instead store them in a related account. Doing so makes it much easier to reconcile the aged accounts receivable report to the trade accounts receivable account.

- *Review the invoice register for missing sales taxes.* It is entirely possible that a new customer will be set up in the customer master file, and a sales tax code will not be included when the company is responsible for collecting sales taxes. To detect missing sales tax codes, print out a version of the invoice register that separately states the amount of sales tax charged, and look for missing sales taxes.

> **Tip:** It is especially efficient to search the invoice register if it can be restricted to show only those states in which the company has nexus for sales tax purposes. This eliminates from consideration all the other states where the company does not have nexus, and so has no liability to collect sales taxes.

- *Adjust default customer addresses for returned mail.* Whenever the postal service returns an invoice, the mailroom staff should route it directly to the accounting department. The accounting staff should work with the sales staff to determine the correct address, and not only reissue the invoice to that address, but also update the address in the customer master file.
- *Reconcile RMAs issued to RMAs received.* There may be a substantial difference between the number of RMAs issued to customers and the number of RMA-authorized returns that have appeared at the receiving dock. The difference represents a possible sales return liability for which the company may want to create a reserve. This means creating an RMA report that itemizes the sales associated with each RMA, and subtracting credits already issued to customers to arrive at the net remaining liability for expected product returns.

> **Associated Policy:** It is reasonable to put a time limit on all RMAs issued, after which the receiving department will no longer accept them. This also places a limit on the size of the sales return liability. A sample policy is: *All RMAs issued shall expire in 30 days from the issuance date.*

- *Reconcile RMAs received to credits issued*. The internal audit staff should occasionally compare the dollar amount of credits issued to the dollar amount at which returned goods were originally sold. There can be differences because the billing clerk forgot to subtract a restocking charge from a credit, or the clerk is issuing credits based on subsequent pricing changes, and so forth. Any issues found should be shared with the billing clerk, and may be incorporated into the credit issuance procedure.

Additional Accounting Policies

There are several supplemental accounting policies that were not mentioned earlier in association with specific controls. These policies are:

- *Invoices shall be issued within one day of shipment or completion of services*. This policy is needed to ensure that the company receives cash from its customers as promptly as possible – which will not happen if they do not receive invoices from the company in a timely manner.
- *Bill and hold invoicing is prohibited*. The concept of billing customers for goods that the company is still holding is subject to abuse, though the accounting standards allow it under tightly controlled circumstances. Generally speaking, it is better to not engage in bill and hold transactions for any reason.

Summary

The control system for customer billings is quite different if a business has a completely computerized order processing system, since the initial order data entry flows all the way through the invoicing process, requiring little additional paperwork or data entry. However, a manual paper flow presents an entirely different scenario, with the billing clerk forced to create invoices "from scratch," and relying upon the proper forwarding of information to the accounting department. In this second scenario, the billing clerk resides at the back end of a long series of activities that pass through many hands, which increases the possibility that the information eventually included in customer billings will be wrong. Consequently, there is a need for a tightly interlocking set of controls to ensure that flawless invoices are issued to customers in a timely manner. Otherwise, a company could suffer severely from delayed customer payments, as customers protest flawed billings.

This chapter was solely concerned with the initial billing to customers and subsequent credits. For information about the controls related to the allowance for doubtful accounts, see the Collection Controls chapter.

Chapter 5 – Review Questions

The review questions accompanying this course are designed to assist you in achieving the course learning objectives. The review section is not graded; do not submit it in place of your qualified assessment. While completing the review questions, it may be helpful to study any unfamiliar terms in the glossary in addition to course content. After completing the review questions, proceed to the review question answers and rationales.

9. Billing to the customer is triggered by:

   a. Receipt of the initial order
   b. Granting of credit by the credit department
   c. Picking of goods from stock
   d. Shipment of the order

10. A reasonable control over website entry of a customer invoice is:

   a. To call and inquire if it was entered properly
   b. To proofread the entry before pressing "enter"
   c. To obtain a confirmation from the website
   d. To obtain a user ID from the website

Chapter 6 – Collection Controls

Learning Objectives
After completing this section of the course, you will be able to:
- Cite the controls that can be used to provide structure to the collections process.

Introduction
Collections is an area in which the risk of nonpayment increases rapidly with time, so there needs to be a strong control system in place for monitoring the activities of the collections staff. Additional controls are needed for writing off uncollectible invoices, and estimating the amount that should be recorded in the allowance for doubtful accounts. In this chapter, we will first address the main activities involved in collections, then describe process-specific controls, and then show the baseline system of controls that should be used. We conclude with a discussion of additional collection controls and related policies.

Related Podcast Episode: Episode 171 of the Accounting Best Practices Podcast discusses collection controls. It is available at: **accountingtools.com/podcasts** or **iTunes**

Collection Process Overview
Accounts receivable collection involves an escalating series of collection activities, which may also require that some portion or all of an invoice be written off. A narrative description of these activities follows.

1. Collection Activities
The collections manager assigns overdue accounts to the collections staff. The staff follows a collection escalation procedure to work with and/or apply pressure to customers to pay their invoices. The level of escalation may eventually reach the point at which further relations with customers will be impaired if additional actions are taken, such as engaging in litigation or terminating any remaining open credit; at this point, the sales manager is usually informed of the situation before proceeding.

2. Write off Balances
If it proves impossible to collect a receivable by any means, the collections person fills out a customer credit request form, stating that the invoice cannot be collected, and requesting elimination of the invoice by applying a credit against it. The collections manager or controller reviews and approves the request and forwards it to the billing clerk, who creates the credit and offsets it against the original invoice in the accounting records. A copy of the credit is *not* sent to the customer, since doing so would inform the customer that the company has terminated any further collection efforts.

The general flow of these collection steps is noted in the following flowchart.

Collection Process Flow

```
                    ┌─────────────────┐
                    │ Overdue accounts│
                    │   assigned to   │
                    │ collection staff│
                    └────────┬────────┘
                             │
                             ▼
                    ┌─────────────────┐
                    │Collection activities│
                    │ follow escalation│
                    │    procedure    │
                    └────────┬────────┘
                             │
                             ▼
                         ◇─────────◇
            No ──────────│Aggressive │
            │            │stance needed?│
            │             ◇─────────◇
            │                  │
            │                 Yes
            │                  │
            ▼                  ▼
   ┌─────────────────┐  ┌─────────────────┐
   │Complete collection│  │  Inform sales   │
   │                 │  │  manager and    │
   │                 │  │  proceed with   │
   │                 │  │   activities    │
   └─────────────────┘  └────────┬────────┘
            ▲                  │
            │                  ▼
            │              ◇─────────◇
            │─── No ───────│Not collectible?│
                            ◇─────────◇
                                 │
                                Yes
                                 │
                                 ▼
                        ┌─────────────────┐
                        │Write off remaining│
                        │    balance      │
                        └─────────────────┘
```
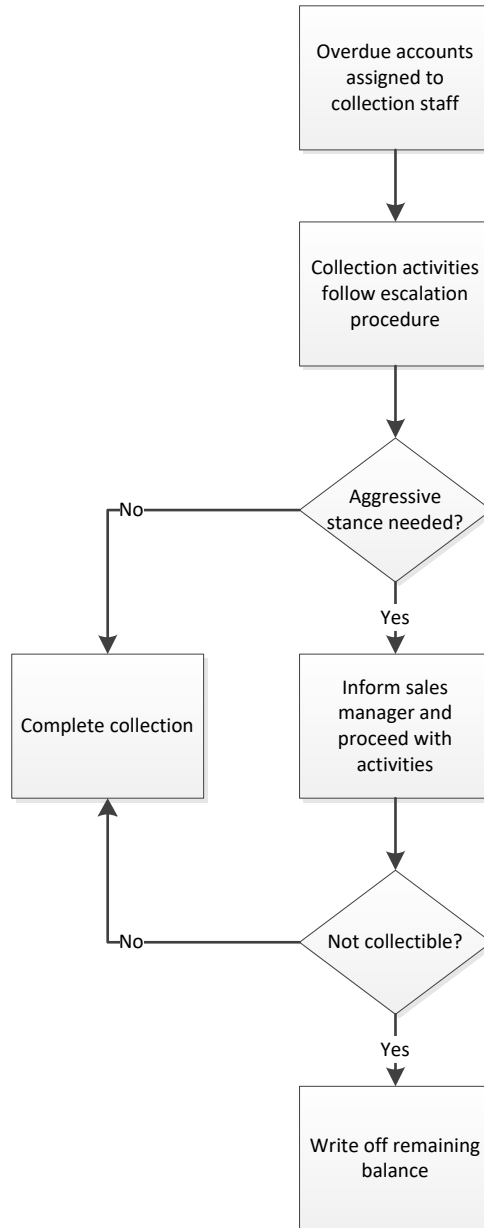
Additional Step – Calculate the Allowance for Doubtful Accounts

Companies have different ways of calculating what their bad debt reserves should be. The general approach is to print the accounts receivable aging report *after* all invoices have been billed for the accounting period, and assign a bad debt percentage to each 30-day bucket in the report. Thus, it might be reasonable to assign a 1% bad debt percentage to all invoices less than 30 days old, a 4% bad debt percentage to those aged between 30 and 60 days, and a 10% bad debt percentage to all older invoices. Another option is to estimate bad debts by individual invoice, though this is more time-consuming and requires excellent knowledge of the payment history of each customer.

Once the total bad debt amount is compiled, it is subtracted from the existing balance in the allowance for doubtful accounts. The difference is added to the account with a journal entry that debits the bad debt expense and credits the allowance account.

In-Process Collection Controls
In this section, we cover the controls that can be imposed on the core collection process. In addition, refer to the Additional Collection Controls section for other controls that are positioned outside of the basic collection activities.

1. Collection Activities
The primary controls over collections are requiring an adequate level of record keeping by the collections staff, and using the resulting information to monitor their activities. The controls are:

- *Use account assignment guidelines*. The collections manager might consider using collection guidelines to decide which collections staff are to be assigned certain accounts. This can have a bearing on situations where certain customers are so difficult to collect from that only the most experienced staff can deal with them.
- *Mandate a collections procedure*. There should be a standard set of activities that the collections staff is required to pursue when contacting customers about collection issues.

> **Tip:** A standard collections procedure may be more applicable for trainee collections personnel, and can be waived to some extent with more experienced employees who know which collection techniques will work with certain customers.

- *Require collections record keeping*. It is impossible to determine the status of an overdue account receivable unless the collections staff maintains adequate records regarding the dates when contacts were made, promises made by customers, and next expected action dates.

> **Tip:** If at all possible, the collections staff should use a collections management system that is integrated into the aged accounts receivable file, which not only increases the efficiency of the department, but also consolidates all collection notes in one place for review by the collections manager.

- *Review collection actions taken*. The collections manager should hold regular meetings with the collections staff to learn about their collection actions taken, as well as expected payments. This is a useful control for ascertaining whether there have been lapses in collection activity.
- *Require supervisory approval of actions taken*. If the collections staff wants to allow delayed or reduced payments, it should first obtain the approval of the collections manager.

> **Tip:** The collections staff should be allowed some leeway in creating payment plans and allowing reduced repayments. Otherwise, the collections manager will be awash in approval forms.

- *Monitor credit levels*. It makes little sense for the collections staff to engage in desperate collection activities against a recalcitrant customer when the company is continuing to sell to the customer. Consequently, a strong control is to give the collections staff input

into the termination or reduction of customer credit during (and after) collection activities.

2. Write off Balances

Only one control is needed over writing off invoices, but it is an important one. The control is:

- *Supervisory approval is needed to write off invoices.* The collections manager or controller should approve the write off of invoices requested by the collections staff. This typically involves a review of all collection actions taken thus far, to ensure that all necessary actions have been taken. It is also necessary to prevent collusion by the collections staff with the cash receipts staff, which could abscond with incoming customer cash and then write off the related invoice.

> **Tip:** From a practical perspective, it is a waste of time to review the write off of smaller invoices, so the collections staff should be allowed to write off invoices below a certain dollar level.

Additional Step – Calculate the Allowance for Doubtful Accounts

In addition to the controls over ongoing collection activities that were just noted, there also need to be several controls over the calculation and updating of the allowance for doubtful accounts. The following controls are particularly useful in situations where the amount of bad debt write offs has historically been significant:

- *Verify that the last period-end aging report is the basis for updating the allowance for doubtful accounts.* This control is not a minor one, since a large amount of month-end invoicing is done at many companies, and the calculated allowance will be too low unless all of the invoices are included in the aging report.

> **Tip:** If there is a month-end closing procedure, insert the updating of this allowance into the procedure *after* the completion of all customer billings, so that the receivables aging report will be fully populated.

- *Require controller approval of changes in the formula used to calculate the allowance for doubtful accounts.* The calculation of the allowance could be modified to meet management's wishes to alter the reported level of profitability. To avoid this issue, the calculation method should be locked down from period to period, and only changed with the direct approval of the controller.
- *Any adjustments to the allowance for doubtful accounts are approved by a supervisor.* The collections manager or controller should approve the proposed journal entry in which the allowance for doubtful accounts is updated. The journal entry should have the calculation of the allowance change attached to it.

Alternative Collection Control Systems

In this section, we assemble a selection of the controls just described and apply them to a typical collections system. The key points are to ensure that the collections staff has an adequate record keeping system for their collection activities, and that the collections manager reviews this information on a regular basis to ensure that these activities are being followed on a timely basis. In addition, a supervisor should approve the write off of larger invoices. These controls are noted in the following control chart, where controls are clustered under the basic collection tasks.

Control System for Collections
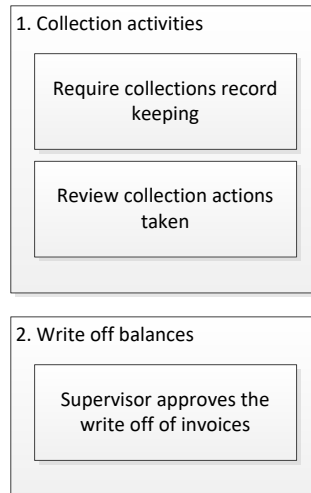
Additional Collection Controls

The following controls are useful for ensuring that the collections staff has the most recent information regarding the status of customer invoices, as well as for tracking collection performance, overseeing the allowance for doubtful accounts, and other matters. They are not necessarily a direct part of the collections process; instead, the collections staff schedules them as separate tasks. These controls are:

- *Use a central collections database*. Install a collections database that is linked to the accounting system, and which the collections staff updates throughout the day. This is perhaps the most effective control that a collections manager can implement, since it gives complete visibility into the workings of the collections staff.
- *Match collection database to aged accounts receivable*. If the collections staff works from a copy of the aged accounts receivable, review the copy to ensure that it matches the most recent information.
- *Require immediate updating of receivable records with cash receipts*. The collections staff may be wasting its time making collection calls on funds that have already been received, so mandate that the cashier apply cash to open accounts receivable at once.
- *Notify the collections staff of changes in credit limits*. The credit manager should notify the collections manager of any prospective or completed changes in customer credit limits.

> **Tip:** The collections manager and credit manager should meet regularly to discuss the more difficult customers. Doing so can trigger changes in customer credit levels, thereby reducing the work load of the collections staff.

- *Track collections on a trend line by collections person*. One of the better ways to judge the collections staff is to track their collections percentage over time. This is not a perfect management technique, since some customers are more difficult to collect from than others.
- *Notify the credit manager of collection trends*. The collections manager should inform the credit manager of any clearly worsening trend in collections. This may call for the

tightening of the corporate credit policy, so that only the more robust customers are allowed large amounts of credit.

- *Track the allowance for doubtful accounts on a trend line*. It may be useful for the controller to track a comparison of the allowance for doubtful accounts to credit sales or accounts receivable, to see if the proportion is changing. If the proportion is declining, it is likely that the external auditors will question the size of the reserve.
- *Review the formula used for the allowance for doubtful accounts*. The controller and credit manager should occasionally review the formula used to derive the balance in the allowance for doubtful accounts, to see if it arrives at a reasonable reserve. This review may be triggered by an event, such as a downturn in the economy.

Additional Accounting Policies

The following policies relate to accounts receivable collections, and involve the management of the department. The policies are:

- *All collections staff shall be assigned specific customers for collection activities*. It is of some importance to assign collection responsibility to specific collection employees. This allows them to learn about the payment characteristics of customers, while also making it clear that they are responsible for overdue payments.

> **Tip:** It may be worthwhile to also assign responsibility for overdue invoices to specific salespeople, and issue aged accounts receivable reports to them that contain only the overdue invoices of the customers for which they are responsible.

- *Account responsibility shall be reassigned at intervals of [time period]*. This policy is designed to forcibly shift customers to different collections personnel from time to time. The advantage of doing so is that collectors can begin to identify too closely with customers, and may become more willing to accept excuses for delayed payments.
- *The collections staff can approve account write-offs of up to $__*. It is inefficient for collections personnel to fully document smaller account write-offs and obtain supervisory approval for them. In many cases, these write-offs are for minor payment variances that would be very inefficient to pursue with customers, and which do not present a risk of fraud. Thus, it is reasonable to allow the collections staff to eliminate them as efficiently as possible.
- *The sales manager shall be notified before any accounts are sent to a collection agency or attorney*. Shifting an overdue invoice to a collection agency or an attorney is a serious step, for it implies that the company is willing to terminate its business relationship with a customer. This policy states that the sales manager should be made aware of these actions before they are taken, in case that person wants to make a last attempt at salvaging the relationship.

Summary

The controls used in the collections area differ from those used for other business processes, because there is not really a regimented collections process. There may be general collection guidelines, but the collections staff usually modifies them to meet the circumstances of each individual collection situation. Since there is no iron-clad process, the controls tend to be of a more general nature, with a focus on giving the collections staff the latest receivable information to use, and ensuring that some sort of ongoing collection activities are being engaged in.

Chapter 6 – Review Questions

The review questions accompanying this course are designed to assist you in achieving the course learning objectives. The review section is not graded; do not submit it in place of your qualified assessment. While completing the review questions, it may be helpful to study any unfamiliar terms in the glossary in addition to course content. After completing the review questions, proceed to the review question answers and rationales.

11.   The allowance for doubtful accounts is commonly calculated:

    a. Under cash basis accounting
    b. Based on billings that have not yet been issued
    c. Solely at the end of the calendar year
    d. By applying a bad debt percentage to each 30-day bucket

12.   A reasonable control over the collections staff is:

    a. Restriction of credit levels granted
    b. Supervisory approval of actions taken
    c. Three-way matching
    d. Review of applied cash

Chapter 7 – Cash Receipts Controls

Learning Objectives
After completing this section of the course, you will be able to:
- State the controls associated with the receipt, recordation, and deposit of cash and checks.

Introduction
Cash receipts is an area in which a poorly-controlled department can lose a large amount of money, since cash is one of the more easily negotiable assets, and so is a continual target for theft. In addition, it is a high-volume application, so some data entry errors will arise occasionally that will require time-consuming investigation and correction. In this chapter, we describe the control systems needed to reduce the risk of theft and errors. We will first address the three main tasks involved in cash receipts, then describe process-specific controls, and then show the control systems most likely to be needed for the following situations:
- Cash receipts system
- Check receipts system
- Lockbox receipts system
- Remote deposit capture

We conclude with a discussion of a number of additional cash receipts controls and related policies.

Related Podcast Episode: Episode 12 of the Accounting Best Practices Podcast discusses cash receipt controls. It is available at: **accountingtools.com/podcasts** or **iTunes**

Cash Receipts Process Overview
Cash receipts processing involves three primary activities, each of which may require controls, depending on the circumstances. The activities are:
1. Accept cash
2. Record cash
3. Deposit cash

A narrative description of these three activities follows.

1. Accept Cash
If a company is paid by customers in cash, a sales clerk usually stores and records the cash in a cash register. If payment arrives by check, it is more likely to arrive through the mailroom, where they are recorded and then sent to the cashier. If customers instead send their payments to a bank lockbox, the bank can either mail copies of the checks and remittance advices to the company, or it can scan and post them on the bank's website. If customers pay with credit cards, this can be done either with a card scanner or by entering the information into an online website form that is maintained by the credit card processor.

2. Record Cash
The cash register results are recorded in the general ledger as sales. If payments are instead made with checks and are in payment of outstanding accounts receivable, the cashier or cash receipts clerk (titles may vary) applies the payments against open accounts receivable in the accounting software. The same approach applies to credit card and lockbox payments.

3. Deposit Cash
For both cash and checks, the cashier prepares a deposit that is then transported to the bank. Lockbox deposits were already sent to the bank by customers, so no additional deposit is required. If the company uses remote deposit capture, it can deposit checks on-site without making a trip to the bank. Remote deposit capture is the use of a scanning device on the company premises to create a legal, scanned image of both sides of a check, which is then uploaded to the bank as a valid deposit. The check used for the scan is not deposited.

Though we have just described the general process flow for cash receipts, it is apparent that the process varies depending on the type of cash received. Therefore, we will now present the same process flow again, but will do so by type of payment.

Cash Payments
When customers pay in cash, it is typically in a retail environment where cash is a preferred mode of payment. In this situation, the company has probably provided its sales clerks with cash registers. The clerks record and store all cash receipts in the cash registers, which are then summarized and recorded in the general ledger or the sales subledger as revenue. In a lower-volume environment, sales clerks may instead use paper receipts to record cash sales. Depending on the sophistication of the cash register and supporting systems, these sales may also identify items sold and relieve them from stock, thereby reducing inventory levels. The cash is then aggregated and shipped to the bank for deposit. These steps are noted in the following flowchart.

Cash Payment Process Flow

```
┌─────────────────────┐        ┌─────────────────────┐
│  Sales clerks record│        │  Sales clerks record│
│  cash through cash  │        │  cash through paper │
│      register       │        │      receipts       │
│   (high volume)     │        │    (low volume)     │
└─────────────────────┘        └─────────────────────┘
            │                              │
            └──────────────┬───────────────┘
                           ▼
              ┌─────────────────────┐
              │   Cashier applies   │
              │  payments to open   │
              │ accounts receivable │
              │   or records as new │
              │        sale         │
              └─────────────────────┘
                           │
                           ▼
              ┌─────────────────────┐
              │  Cashier prepares   │
              │    deposit slip     │
              └─────────────────────┘
                           │
                           ▼
              ┌─────────────────────┐
              │ Deposit is physically│
              │  transferred to the │
              │        bank         │
              └─────────────────────┘
```
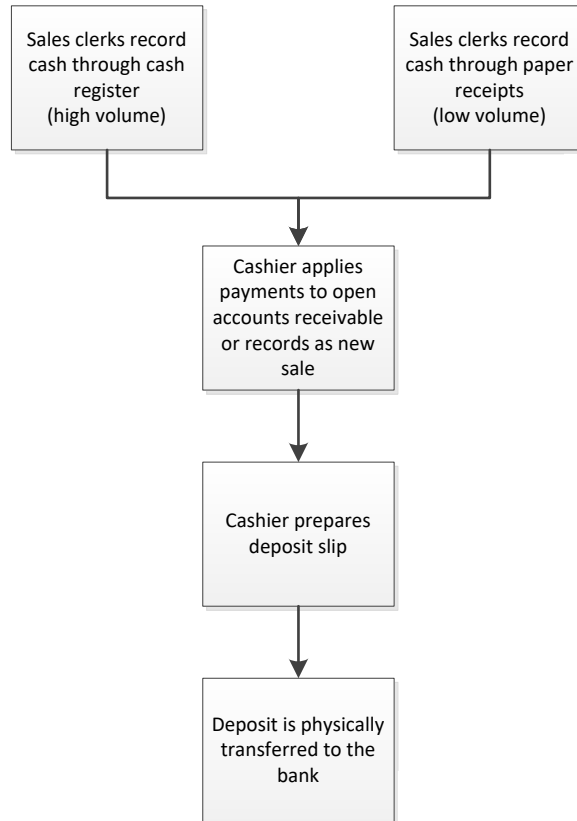
Check Payments

When customers send checks to a company, they may either send them directly to the company's bank lockbox or to the company. In the first case, the bank deposits the funds at once, and either sends check copies to the company or notifies it that scanned images of payments are now available on the bank's web site. No matter what the initial channel of receipt may be, the company's cashier applies these payments against unpaid accounts receivable. This usually means accessing a cash application module in the accounting software, entering each payment into the system, and applying it to invoices. It may be impossible to apply some cash, perhaps because the payer is unknown or the invoices being paid were not identified by the customer. These payments are usually recorded in a suspense account for later review. Once all cash application is completed, the cashier prints a cash receipts journal that details all of the receipts applied. The checks are then shipped to the bank for deposit. If the company is instead using remote deposit capture to scan checks on-site and send an electronic deposit to the bank, it retains the checks until such time as the bank confirms the deposit, and then shreds them. These steps are noted in the following flowchart.

Check Payment Process Flow


```
┌─────────────────┐          ┌─────────────────┐
│ Bank records    │          │ Mailroom staff  │
│ cash and checks │          │ receives checks │
│ sent to lockbox │          │ paid through    │
│                 │          │ the mail        │
└─────────────────┘          └─────────────────┘
```

Cashier applies payments to open accounts receivable or records as new sale

Remote deposit capture?

No → Cashier prepares deposit slip for payments received directly → Deposit is physically transferred to the bank

Yes → Cashier uses remote deposit capture to scan and deposit checks

Credit Card Payments

A completely unrelated form of cash receipt is when a customer pays with a credit card. This payment can be completed in a number of ways, such as with a card swipe, entry into a smart phone, or manual entry into an online form. The most complex of these variations is to enter the information into an online form, so we will assume that approach for the purposes of describing the process. When entering credit card information into an online form, you are typically required to enter the name and address of the card holder, as well as the information on the card. Given the amount of information required, a form is usually completed to ensure that all required information is collected. The designated person then logs into the credit card processing site, enters the information, along with the invoice number being paid (if any), and prints out a transaction verification form. Since the credit card payment is not linked to the company's cash receipts system, the accounting staff must now enter the cash receipts program, designate the receipt as a credit card payment, and use it to pay for the invoice (if any). The customer will

likely want a receipt, so the staff must also make a copy of the invoice, stamp "Paid" on it, and mail it to the person who paid for it. These steps are noted in the following flowchart.

Credit Card Payment Process Flow

```
                    ┌─────────────────┐
                    │ Collect credit  │ ─ ─ ─ ─ ─ ─ ─ ┐
                    │ card and receipt│               ▼
                    │ mailing         │        ┌──────────────┐
                    │ information from│        │ Credit card  │
                    │ customer        │        │ payment form │
                    └─────────────────┘        └──────────────┘
                             │                        │
                             ▼                        │
                    ┌─────────────────┐               │
      No            │ Enter credit    │ ◄ ─ ─ ─ ─ ─ ─ ┘
                    │ card information│
                    │ into on-line    │
                    │ form            │
                    └─────────────────┘
                             │
                             ▼
                         ╱Accepted?╲ ─ ─ ─ ─ ▶ ┌──────────────┐
                         ╲         ╱           │ Acceptance   │
                             │                 │ notification │
                            Yes                └──────────────┘
                             ▼                        │
                    ┌─────────────────┐               │
                    │ Apply amount    │ ◄ ─ ─ ─ ─ ─ ─ ┘
                    │ paid to invoice │
                    │ in accounting   │
                    │ system          │
                    └─────────────────┘
                             │
                             ▼
                    ┌─────────────────┐
                    │ Send copy of    │
                    │ invoice with    │
                    │ ""Paid" stamp   │
                    │ to credit card  │
                    │ holder          │
                    └─────────────────┘
```
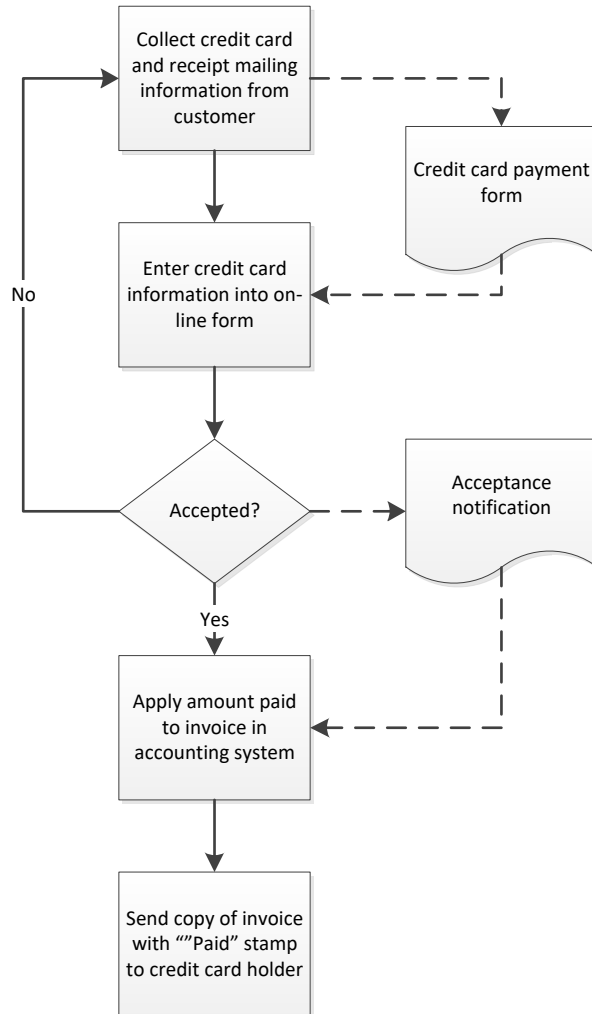
In-Process Cash Receipts Controls

In this section, we cover the controls that can be imposed on the core cash receipts activities. The list appears long, because different controls apply only to certain types of cash receipt, such as checks, cash, or credit cards. For a more specific matching of controls to payment types, see the Alternative Cash Receipts Control Systems section. Also, refer to the Additional Cash Receipts Controls sections for other controls that are positioned outside of the basic cash receipts transactions.

1. Accept Cash
This section includes controls for three very different types of payment – checks sent to the company, checks sent to a lockbox, and cash. As you peruse these controls, it will be clear that the area most inundated with controls is the receipt of cash, which is needed to prevent theft. The controls are:

- *Open the mail and record cash receipts*. Someone not otherwise involved in the handling or recordation of cash receipts opens the mail, records all cash and checks received, and then forwards the cash receipts to the cashier. To strengthen this control, have two people jointly open the mail.

> **Tip:** If there is only one person in the mailroom, call in a clerk from another part of the company just to participate in the recordation of cash receipts.

- *Endorse for deposit only*. The person opening the mail should also immediately endorse all checks received with a "For Deposit Only" stamp, preferably one that also lists the company's bank account number. This makes it much more difficult for someone to extract a check and deposit it into some other account.
- *Direct payments to lockbox*. An excellent control is to set up a lockbox at a bank, and direct customers to send their payments directly to the bank. This eliminates all risk of cash or checks being stolen from within the company, and may also accelerate the recognition of cash in the company's bank account by a day or so.

> **Tip:** When setting up a bank account, send a notification letter to all customers to point out the address to which they should now send their checks. Then monitor subsequent payments sent directly to the company, and call those customers to reinforce the change to the lockbox address. It may require multiple notifications before all customers are routinely mailing their payments to the correct location.

- *Record cash in cash register*. The primary purpose of a cash register is as its name indicates – it registers the amount of cash received. Therefore, when there is any reasonable expectation for a large number of cash receipts, always have a cash register available for recording the transactions.
- *Record cash on pre-numbered receipts*. In situations where relatively small quantities of cash are anticipated, it may not be cost-effective to operate a cash register. If so, record cash received on pre-numbered receipts, and be sure to use the receipts consecutively. By doing so, you can scan through the numbers on the receipts to see if any receipts are missing. A missing receipt indicates that cash has not been recorded.
- *Give receipt to customer*. If a customer is paying with cash, have cashiers give customers a copy of the receipt. If the cash is recorded in a cash register, the amount printed on the receipt will match the amount punched into the register. If the cash is recorded on pre-numbered receipts, the form should be a two-part form, so that the amount written on it by the clerk is identical for the versions kept by the customer and the company. Handing over a receipt is a reasonable control, since it means that the recipient might examine the receipt to see if the amount recorded matches what they paid.

> **Associated Policy:** Clerks should always hand the receipt to the customer, or at least put it in the shopping bag. There should not even be an option to throw away the customer's copy. This can be reinforced with the following control: *Sales clerks shall give a receipt to all customers, without exception*.

- *Match cash register cash to receipts*. Once a sales clerk's shift has ended, have a third party match the amount of receipts recorded by the register to the total amount of cash in the register. This should be recorded on a signed reconciliation form.

2. Record Cash

The recordation of cash within the accounting system is essentially the same for all types of payment, with the main difference being that the cashier should record the type of payment received when recording each payment. Thus, there should be a "cash," "check," or "credit card" flag in the software.

This makes it easier to later track down the types of cash payments made. The controls for recording cash are:

- *Apply cash at once*. There are several reasons why the cashier should apply cash to customer accounts as soon as the cash is received. First, it removes overdue accounts receivable from the aged receivables report, and therefore keeps the collection staff from wasting time on collection calls. Also, immediate cash application means that the cash will then be shifted off the premises and deposited, leaving little time for anyone to steal it.

> **Associated Policy:** For the reasons just noted, it is excellent practice to apply all incoming cash to accounts receivable at once. This can be supported with the following policy: *All cash receipts shall be applied to cash within one business day of receipt.*

- *Apply cash based on check copies*. This control can be applied in two situations. If the company is using a bank lockbox, the bank will either mail copies of all checks and remittance advices received to the company, or it will make them available on a website as scanned images; in either case, the cashier uses these documents as the basis for cash applications. In the second situation, the cashier photocopies all checks, thereby allowing for the immediate deposit of the checks and a somewhat more leisurely application of the payments to outstanding receivables.
- *Record undocumented receipts in a clearing account*. One of the best ways to destroy accounts receivable record accuracy is to apply cash receipts to receivables even when there is no indication of the invoice numbers to which they should be applied. Instead, these receipts should always be recorded into a clearing account for further review.
- *Match documents*. The cashier should match the initial list of checks generated by the person opening the mail to the related cash receipts journal. This highlights cash that the cashier may not have applied to receivables, and will also spot any cash that was removed between the mailroom and the cashier's office.
- *Review restrictive endorsements*. Some customers occasionally state on a check payment that it constitutes full payment of a debt, so cashing the check means that the recipient agrees with the statement. This could result in the company not being able to collect on any remaining unpaid balance on an invoice. To avoid this issue, the cashier can examine checks for restrictive endorsements and set them aside for review by the controller.

3. Deposit Cash

The depositing of cash and checks is essentially the same, since they are routinely recorded under a single deposit slip and transported to the bank together. This means that their deposit-related controls are identical. However, if the company uses remote deposit capture to scan checks on-site and send an electronic file to the bank, there are different controls for those checks. The controls are noted below:

- *Deposit daily*. If checks or cash are left on-site overnight, there is an increased chance that they may be stolen. To mitigate this risk, always deposit cash and checks at the end of every business day.

> **Associated Policy:** To encourage the accounting staff to make deposits every day, adopt the following policy: *All cash and checks shall be deposited on the same day as the day of receipt.*

- *Lock up cash during transport*. Store all cash in a locked container while transporting it to the bank for deposit. This is not a good control, since someone could steal the entire container. A better approach for transporting large amounts of cash is to hire an armored car company to transport the cash on behalf of the company.
- *Match cash receipts journal to bank receipt*. When funds are deposited at the bank, the bank clerk hands over a receipt for the amount deposited. The person transporting the cash to the bank gives this receipt to the cashier, who compares it to the cash receipts journal. If the numbers do not match, it may mean that the person transporting the cash removed some cash prior to the deposit, though it may also mean that either the cashier or the bank incorrectly recorded the amount of cash.
- *Match remote deposit capture report to cash receipts journal*. If the company is using a check scanner to convert checks to electronic images and deposit them remotely, the scanning software should generate a report that shows the images of all checks scanned. Compare this report to the cash receipts journal to ensure that all checks were scanned and accepted by the bank. Also, store a copy of the report as evidence of transmission to the bank.
- *Destroy scanned checks*. If the company is using remote deposit capture to scan checks on-site, the checks could still be incorrectly included in a normal deposit to the bank. To avoid this, either destroy the scanned checks entirely or perforate or disfigure them to such an extent that they could not reasonably be deposited.

> **Tip:** It is not a good idea to immediately destroy a check that has been scanned into a remote deposit capture system, since image quality issues might require use of the original check. To mitigate this risk, retain all scanned checks in a locked location for 15 business days, and then destroy them. To be very sure of the check destruction, have someone sign a document destruction certificate for all checks shredded.

Credit card payments do not involve the handling of cash, so their controls are quite different from the ones used for cash. Possible controls include:

- *Use a form to take down information*. If a company manually enters credit card information into an online site, there is a significant chance that the information it enters will be incorrect in some respect, and so will be rejected. To reduce this risk, use a standard form to take down the name, billing address, and credit card information associated with the card being used to pay an invoice, as well as the name and address to which a receipt should be sent, and the number of the invoice being paid. The form should also require a phone number for the person paying the invoice, in case you need to call them back to verify the information or ask for a different credit card number.
- *Reconcile credit card receipts to accounts receivable*. When cash appears on the bank statement from a credit card transaction, have a procedure to trace it back to cash applied to specific accounts receivable. Otherwise, there is a chance that you will process a credit

card but forget to also process the matching cash receipt against the related customer invoice.

Tip: When entering credit card payments in the cash receipts system, always designate them as credit card payments. A report can then be created that shows only the credit card payments assigned to receivables during the month. Compare the amounts on this report to the receipts appearing on the bank statement to ensure that all credit card payments were applied against open receivables.

Alternative Cash Receipts Control Systems

In this section, we assemble a selection of the controls just described and apply them to different cash receipts scenarios involving the receipt of cash, checks, lockbox receipts, and deposits using remote deposit capture. While there are certain similarities in the controls used for each system, there are also crucial differences to consider when constructing your own system of controls.
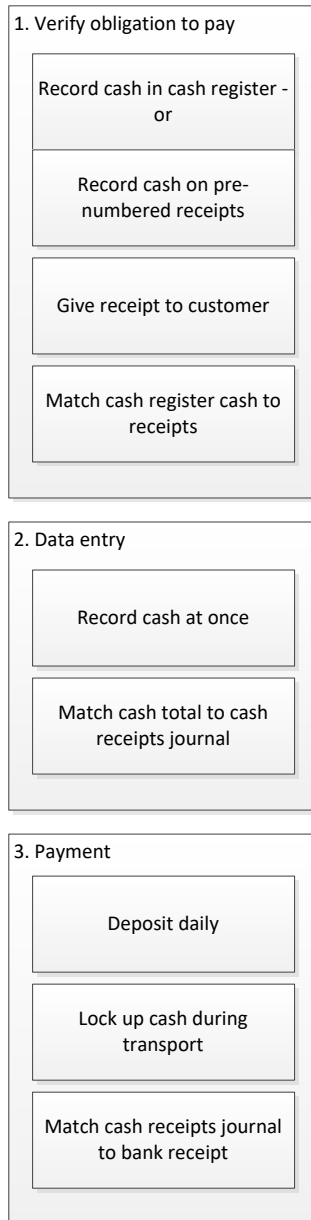
Control System for Cash Receipts

The controls for cash are more involved than the controls for checks, since cash is more easily negotiable, and is therefore more likely to be stolen. The first control in the process for receiving cash is to write down the amount paid and share this information with the customer; the hope is that the customer will examine the receipt and see if it matches what was paid. The cash is then periodically batched and compared to the company's copies of all cash receipts to ensure that they are the same. The cashier then records the cash in the accounting system and verifies that the resulting cash receipts journal matches the cash receipts.

Cash is transported to the bank in a sealed and locked container for daily deposits. After the bank receives and counts the cash, it issues a receipt, which is compared to the cash receipts journal. By comparing the initial cash receipts to the cash receipts journal and bank receipt, we can ensure that the same amount of cash received is recorded and deposited.

These controls are noted in the following control chart, where controls are clustered under the basic cash receipts tasks.

Control System for Cash Receipts

1. Verify obligation to pay

Record cash in cash register - or

Record cash on pre-numbered receipts

Give receipt to customer

Match cash register cash to receipts

2. Data entry

Record cash at once

Match cash total to cash receipts journal

3. Payment

Deposit daily

Lock up cash during transport

Match cash receipts journal to bank receipt

Control System for Check Receipts

The most common set of cash receipts controls are used for the handling of checks. This begins with having the mailroom staff open the mail and make a list of all checks received, as well as endorse them for deposit only. The mailroom staff keeps a copy of the checks received list, and forwards a copy to the cashier, along with the checks. The cashier applies the checks to open accounts receivable as soon as possible, and records all unmatched payments in a clearing account for later disposition. The cashier then prints the cash receipts journal from the computer system and matches it against the checks list forwarded by the mailroom staff. Finally, all checks are deposited at the bank on a daily basis, and the bank's receipt is matched against the cash

receipts journal. The general point behind matching the checks list, cash receipts journal, and bank receipt are to ensure that the same amount of checks received are recorded and deposited.

These controls are noted in the following control chart, where controls are clustered under the basic cash receipts tasks.
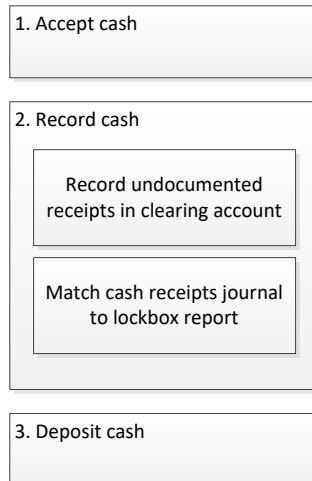
Control System for Check Receipts

```
┌─────────────────────────────────┐
│ 1. Accept cash                  │
│  ┌───────────────────────────┐  │
│  │  Open mail and record cash │ │
│  │          receipts          │ │
│  └───────────────────────────┘  │
│  ┌───────────────────────────┐  │
│  │   Endorse for deposit only │ │
│  └───────────────────────────┘  │
└─────────────────────────────────┘

┌─────────────────────────────────┐
│ 2. Record cash                  │
│  ┌───────────────────────────┐  │
│  │     Apply cash at once      │ │
│  └───────────────────────────┘  │
│  ┌───────────────────────────┐  │
│  │   Record undocumented       │ │
│  │ receipts in clearing account│ │
│  └───────────────────────────┘  │
│  ┌───────────────────────────┐  │
│  │ Match cash receipts journal │ │
│  │       to checks list        │ │
│  └───────────────────────────┘  │
└─────────────────────────────────┘

┌─────────────────────────────────┐
│ 3. Deposit cash                 │
│  ┌───────────────────────────┐  │
│  │        Deposit daily        │ │
│  └───────────────────────────┘  │
│  ┌───────────────────────────┐  │
│  │ Match cash receipts journal │ │
│  │      to bank receipt        │ │
│  └───────────────────────────┘  │
└─────────────────────────────────┘
```
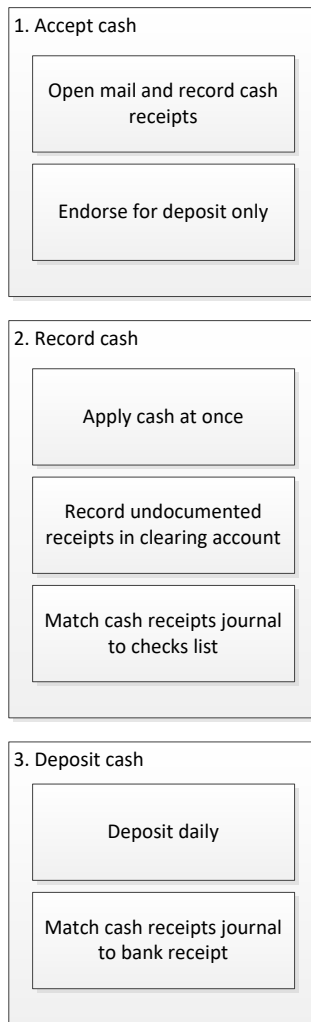
Control System for Lockbox Receipts

When cash is received at the bank lockbox, far fewer controls are needed over cash receipts, since there is no cash on the company's premises. The only controls left are to continue to record undocumented receipts in a clearing account, and to match the cash receipts journal to the report of cash received from the lockbox operator. The notable absence of controls in the following control chart might be a sufficient inducement to switch over to a lockbox system.
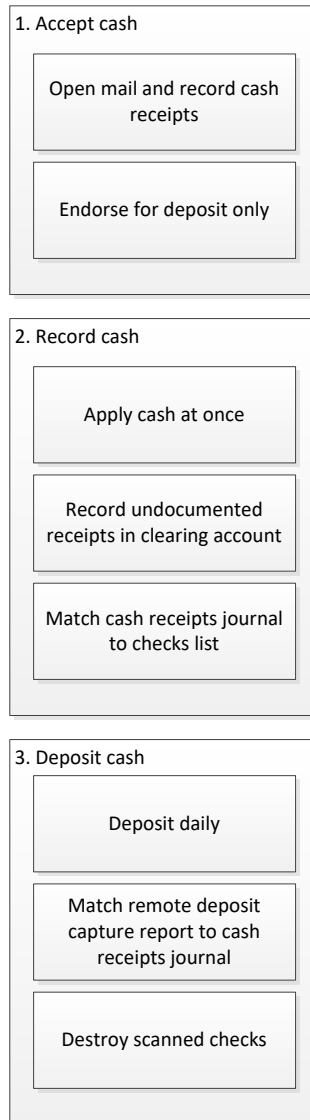
Control System for Lockbox Receipts

```
1. Accept cash
```

```
2. Record cash

    Record undocumented
    receipts in clearing account

    Match cash receipts journal
    to lockbox report
```

```
3. Deposit cash
```

Control System for Remote Deposit Capture

In a remote deposit capture situation, the only change from normal check processing is that there is no physical delivery of checks to the bank. Instead, the accounting staff scans the checks and submits the resulting electronic file to the bank. The two applicable controls are to ensure that the amount scanned matches the amount recorded in the cash receipts journal, and that the scanned checks are eventually destroyed. These controls are noted in the following control chart, where controls are clustered under the basic cash receipts tasks.

Control System for Remote Deposit Capture

```
┌─────────────────────────────────┐
│ 1. Accept cash                  │
│  ┌───────────────────────────┐  │
│  │ Open mail and record cash │  │
│  │ receipts                  │  │
│  └───────────────────────────┘  │
│  ┌───────────────────────────┐  │
│  │ Endorse for deposit only  │  │
│  └───────────────────────────┘  │
└─────────────────────────────────┘

┌─────────────────────────────────┐
│ 2. Record cash                  │
│  ┌───────────────────────────┐  │
│  │ Apply cash at once        │  │
│  └───────────────────────────┘  │
│  ┌───────────────────────────┐  │
│  │ Record undocumented       │  │
│  │ receipts in clearing account │
│  └───────────────────────────┘  │
│  ┌───────────────────────────┐  │
│  │ Match cash receipts journal │ │
│  │ to checks list            │  │
│  └───────────────────────────┘  │
└─────────────────────────────────┘

┌─────────────────────────────────┐
│ 3. Deposit cash                 │
│  ┌───────────────────────────┐  │
│  │ Deposit daily             │  │
│  └───────────────────────────┘  │
│  ┌───────────────────────────┐  │
│  │ Match remote deposit      │  │
│  │ capture report to cash    │  │
│  │ receipts journal          │  │
│  └───────────────────────────┘  │
│  ┌───────────────────────────┐  │
│  │ Destroy scanned checks    │  │
│  └───────────────────────────┘  │
└─────────────────────────────────┘
```

Additional Cash Receipts Controls – Fraud Related

There is a reasonable chance that fraud will occur in the cash receipts area, since cash is such an obvious target. There are many fraud controls, so we have segregated them into controls that apply in general to all forms of payment, to cash payments, and to credit card payments. The controls are:

General Fraud Controls

The following controls are useful for preventing or detecting fraud for all types of cash receipts:

- *Separation of duties*. To reduce the risk of cash theft, have one person open the mail and record cash receipts, another person record the cash in the accounting records, and (if possible) a third person deposit the cash at the bank. Where possible, anyone involved in the handling of cash should not have access to the customer billing system, since

someone could steal cash from a customer and then hide the theft by issuing a credit to the customer to cancel their related receivable.

> **Tip:** The separation of duties can be extremely difficult in smaller companies where there are not enough employees in the accounting department. If so, consider having a mailroom clerk or the receptionist open the mail and record cash, which provides initial evidence of cash receipt. Another option is to pay the outside auditors to conduct especially detailed auditing procedures on cash receipts as part of their year-end audit of the financial statements.

- *Require vacations by cash receipts staff.* There are various types of fraud where employees can cash checks paid by customers and then hide their activities through various alterations of the accounts receivable records. This requires constant manipulation of the accounting records, so forcing employees to take their accrued vacation time is a good way to see if any issues arise during their absence.
- *Request ACH payment.* The best preventive control of all for cash receipts is to have no cash to receive. This can be done by asking customers to pay with direct deposit (Automated Clearing House) transactions that shift funds directly into the company's bank account.

> **Tip:** Though rarely agreed to by customers, it may be worthwhile to ask if payments can be made by having the company initiate an ACH debit of customer bank accounts. This is an electronic transfer that is under the control of the company. It is also an excellent way to ensure that payments are made on time. Customers do not like it, because they have little control over payments, other than an outright block of an ACH debit.

- *Lock up deposits overnight.* There will be cases where cash and checks are held on the premises overnight, perhaps because they were received too late on the previous day to make a deposit, or perhaps due to a banking holiday. These overnight deposits should always be stored in a locked location, preferably in a safe.
- *Confirm cash receipts system access.* Only a small number of people should be allowed to apply cash to accounts receivable under the separation of duties concept. To see if this is the case, periodically examine the access log for the cash receipts module. Also require password access to the cash receipts system, and require regular changes to the password.
- *Trace check images back to the cash receipts journal.* If there is not a sufficient separation of duties, it is possible that the person recording cash receipts could claim that a customer took an early payment discount or some other type of discount, and then pocket the difference. This can be detected by tracking check images back to the cash receipts journal.

> **Tip:** The easiest way to obtain images of checks is to access them on the bank's web site. Few banks still return cancelled checks with their monthly bank statements, so online access is the preferred method.

- *Verify checks from unknown buyers who want immediate delivery.* When a new customer is willing to pay with a check for immediate delivery of a product, this could be a scam, since the check might be counterfeit or drawn on an account that has insufficient funds. Thus, always verify these checks prior to delivering goods.

Cash-Related Fraud Controls
There are a number of additional controls that can reduce or at least detect fraud when cash is being paid. The following controls include several reports that can indicate the presence of fraud, as well as make sales clerks think twice before taking cash from their cash registers:

- *Run gross margin trend analysis*. There may be cases where employees are taking cash at the point of sale, and destroying the evidence of the sale. The possible presence of this theft can be detected by running a trend line of the company's gross margin. The cost of goods sold should be increasing in proportion to sales, since goods are still being sold, but the related sales are not being recorded.

> **Tip:** In a larger company, stealing cash at the point of sale is difficult to detect, simply because it is such a small amount in relation to total sales. The odds of detection can be improved if there is a way to isolate both sales and the cost of goods sold by store or territory.

> **Tip:** Trend analysis is also useful for specific types of cash receipts. For example, if a manufacturing operation generates a large amount of scrap, it is probably being sold to a local scrap dealer. Use trend analysis to see if the amount of cash received from the scrap dealer is reasonable. A declining trend indicates that someone is intercepting the cash before it reaches the cashier.

- *Supervisors approve cash refunds*. A supervisor should be required to override a cash register to allow cash refunds to customers. Otherwise, a sales clerk could create a fake refund transaction and pocket the cash. This tends to be a relatively weak control that is only perfunctorily observed by supervisors, but it must be used to act as a deterrent.
- *Run cash refunds trend analysis*. Compile information about the proportion of cash refunds to sales for each sales clerk or cash register. This may spot unusually high proportions of refunds to sales, which can indicate cash being removed from the register by the sales clerk and hidden with a refund transaction.

> **Tip:** This trend line analysis can be complicated. For example, if a sales clerk always staffs an area in a certain part of a store that normally experiences a higher-than-normal amount of refunds, the trend analysis might highlight that clerk, even though there is no fraud. For example, there may be a normally higher rate of return in the fragrances area than in the housewares department.

- *Limit cash register access*. Ideally, only one sales clerk should operate a cash register between reconciliations, since any cash shortfalls will then be the clear responsibility of the clerk. This is difficult from a practical perspective, since clerks need to take breaks, and someone else will likely operate the cash register in their absence. Thus, responsibility for a register can be somewhat diffused.

> **Tip:** A more advanced cash register requires that the operator log in, which makes it easier to determine who was operating the machine during the day. This log in control is a weak one if the access codes are well-known.

- *Install cash register video surveillance*. Sales clerks will be less likely to attempt to pocket cash from a sale if they know they are being observed with a video camera. It may not be necessary to monitor the video at all, since it is both unutterably dull to do so and unlikely to spot any activity. However, it provides a historical record that may be useful

for researching potential fraud after the fact, and also acts as a deterrent to sales clerks if they know they are being monitored.

Credit Card-Related Fraud Controls

The following two controls are designed to prevent unauthorized access to customer credit card information that the company has used to charge customers. They are not part of the normal cash receipts process flow, but are necessary to protect customer interests. The controls are:

- *Shred or secure credit card numbers*. If the accounting staff writes down customer credit card numbers in order to charge the cards for sales, it needs to either shred the documents containing the card numbers or lock them in a secure location. This is a particular problem when the staff takes down *complete* card holder information, since this can be used to make fraudulent purchases.

> **Tip:** Some customers want their monthly billings to be charged to the same credit card, month after month. While this is fine from a cash collection perspective, it does present a security risk. Be especially careful to lock up this information, not only to prevent its theft, but also to avoid a breach of faith with the customer. After all, customers are not likely to make credit card purchases with you again if your actions resulted in fraudulent use of their cards in the past.

- *Password-protect the customer master file*. If the company stores customer credit card information in the customer master file, ensure that access to that file is password-protected, and that the password is changed regularly.

Additional Cash Receipts Controls – Periodic Actions

The following controls are useful for keeping costs down or making cash receipt operations more efficient. They are not necessarily part of a specific process; instead, the accounting staff schedules them as separate tasks. These controls are:

- *Conduct daily bank reconciliations*. It is extremely useful to access online account information at the bank's website and use it to update the company's bank reconciliation every day. By doing so, you can see if deposits arrived at the bank on time, and were correctly recorded by the bank. This also gives the company early notice of any customer checks that were rejected by the bank.
- *Update clearing account*. The accounting staff should be recording undocumented cash receipts in a clearing account for further investigation. It should be standard practice to review this account every day, to determine how the cash should be applied. Otherwise, accounts receivable may remain open much longer than would normally be the case, and the collections staff may contact customers who have already paid.
- *Route receipts to lockbox*. When a company directs its customers to make their payments to a bank lockbox, some payments will still inevitably be sent to the company instead. When these payments arrive, it may be easier to mail them straight to the bank lockbox, rather than trying to route them through the old in-house cash receipts processing system. By having every receipt go through the lockbox, any in-house handling of cash can be avoided.
- *Review auto cash results*. Some companies use automatic cash application software (also known as auto cash) to apply cash receipts to open invoices. A variety of rules can be used to apply cash, such as only applying cash if it exactly matches the amount of those invoices that have recently come due for payment, or if the match is within a few percent

of the invoice amount. If these rules are set incorrectly, the system can cause many incorrect cash applications. Consequently, a periodic examination of auto cash results, with related tweaking of the cash application rules, is a good idea.

Additional Accounting Policies

There is a supplemental accounting policy that was not mentioned earlier in association with specific controls. That policy is that unapplied cash shall be reviewed daily. In some businesses, there may be a substantial amount of customer payments that cannot be traced to specific invoices, and so are recorded in a suspense account. A policy should require that these amounts are examined every day, so that proper postings can be completed in a timely manner.

Summary

Cash receipts is one of the most fragmented processes within a company, since customer payments can arrive through multiple channels (lockboxes, cash registers, the mail, and directly into its bank account) and may take many forms (cash, checks, credit cards, and electronic payments). The result is a large number of procedures to handle every possible scenario. One of the better ways to manage this mess is a continuing effort to shift customers into a single form of payment, around which the company can set up a robust set of controls. However, there will always be a residual number of payments coming through a less-preferred channel and in a less-preferred form. Consequently, there will always need to be a system of controls to cover every possible form of payment, but there will usually be one type of payment that greatly exceeds all other types – and that form of payment should be surrounded by a strong control system.

Chapter 7 – Review Questions

The review questions accompanying this course are designed to assist you in achieving the course learning objectives. The review section is not graded; do not submit it in place of your qualified assessment. While completing the review questions, it may be helpful to study any unfamiliar terms in the glossary in addition to course content. After completing the review questions, proceed to the review question answers and rationales.

13.   When a payment does **NOT** identify the invoice being paid:

    a. It is returned to the customer
    b. It is recorded in a suspense account
    c. It is retained by an independent custodian
    d. It is paid to the state government under escheat laws

14.   The advantage of applying cash from check copies is that:

    a. There is no advantage to applying cash from check copies
    b. They are more legible than the originals
    c. Check deposits can be made by the mailroom staff
    d. Checks can be deposited faster

Chapter 8 – Purchasing Controls

Learning Objectives
After completing this section of the course, you will be able to:
- Identify the different types of controls that can provide structure to the purchasing function.

Introduction
Purchasing involves the channeling of requisitions from everywhere in a company to the purchasing department, which uses various spend management methods to place orders with suppliers. In this chapter, we describe the control systems used to monitor purchases. We will first address the four main tasks involved in purchasing, then describe process-specific controls, and then show the control systems most likely to be needed for the following situations:
- Purchasing with bids
- Purchasing without bids
- Purchasing with a computerized system

We conclude with a discussion of a number of additional purchasing controls and related policies.

> **Related Podcast Episode:** Episode 5 of the Accounting Best Practices Podcast discusses purchase order controls. It is available at: **accountingtools.com/podcasts** or **iTunes**

Purchasing Process Overview
Purchasing involves four primary activities, each of which may require controls, depending on the circumstances. The activities are:
1. Purchase requisition
2. Bidding
3. Order derivation
4. Order monitoring

A narrative description of these four activities follows.

1. Purchase requisition
The purchasing process begins with someone filling out a requisition form, in which they state what they want the purchasing staff to buy. The form is in duplicate, so that the person filling out the request can retain a copy. If the company has an online ordering system, the person completes an online form, and the system sends an acknowledging email. In either case, the requisition is sent to the purchasing department.

2. Bidding
If a requisition is for a large enough amount of money, the purchasing staff goes out for bid in order to obtain the best deal. This is an increasingly rare circumstance, as more businesses are trying to reduce the number of suppliers they use and accelerate the purchasing process. Still, it is sometimes used, especially in government purchasing. If a company engages in bidding, there

will likely be a bidding packet assembled that documents who was contacted, the resulting bids, and why the winner was selected.

3. Order derivation
Once a supplier has been selected, the purchasing staff creates a multi-part purchase order that authorizes a purchase. One copy goes to the supplier, one is retained in the purchasing department and matched to the original requisition form, and other copies go to the receiving and accounting departments. The receiving department needs to refer to the purchase order when the goods arrive, and the accounting department needs it for three-way matching (see the Accounts Payable Controls chapter). It is possible that another copy is sent to the requisitioning department, in case they want to match it with their copy of the originating requisition.

If an order is too small to warrant the use of a purchase order, the purchasing staff may instead use a procurement card. Doing so avoids a considerable amount of paperwork. See the Procurement Card Controls chapter for more information.

4. Order monitoring
The purchasing staff monitors open purchase orders to ensure that suppliers complete them by the required due date, and then close out any residual balances on orders that have been mostly filled. The department may extend its order monitoring to a more formal rating system for suppliers, which it uses to determine its preferred list of suppliers.

The general flow of these four purchasing steps, including the associated paperwork, is noted in the following flowchart.

Purchasing Process Flow

```
            ┌─────────────────┐
            │ Employee prepares│
            │ purchase        │
            │ requisition     │
            │ form            │
            └────────┬────────┘
                     │
                     ▼
            ┌─────────────────┐
            │ Requisition copy│
Employee ◄──│ Requisition Form│
retains copy└────────┬────────┘
                     │
                     ▼
┌──────────┐  ┌─────────────────┐
│Bid package│◄─│ Engage in bid   │
└──────────┘  │ process if large│
              │ enough          │
              └────────┬────────┘
         ┌─────────────┴──────────┐
         ▼                        ▼
┌─────────────────┐    ┌─────────────────┐
│If small         │    │If large         │
│expenditure, buy │    │expenditure,     │
│with a           │    │create purchase  │
│procurement card │    │order            │
└─────────────────┘    └────────┬────────┘
```

Employee retains copy

Bid package

If small expenditure, buy with a procurement card

If large expenditure, create purchase order

Purchase order copy

Purchase order copy

Purchase order copy

Purchase order

To accounts payable for three-way matching

To receiving department to match against receipts

To supplier

Retained by purchasing; for monitoring subsequent activity

In-Process Purchasing Controls
In this section, we cover the controls that can be imposed on the core purchasing processes. In addition, refer to the Additional Purchasing Controls sections for other controls that are positioned outside of the basic purchasing transactions.

1. Purchase Requisition
There needs to be a properly organized system for bringing purchasing requests into the purchasing department. The core of this system is the purchase requisition, which is itself a control over the accuracy of information provided and the authorization to purchase something. The controls related to purchase requisitions are:

- *Require purchase requisition*. One of the larger problems in the purchasing area is being inundated with purchasing requests from everyone in the company who wants to buy something. Not only is this disorganized, but it also introduces a control problem where any*one* can order any*thing*. The solution is to require all requesters to fill out a purchase requisition form that identifies exactly what someone wants to buy (with complete specifications, and preferably the account to be charged). This form should be signed by the person whose department will be charged for the item being requested.

> **Tip:** It may be necessary to include various approval levels on the purchase requisition form, in case some requests are very expensive.

- *Use prenumbered purchase requisitions*. If purchase requisitions are to be used, prenumber the forms. The purchasing staff can then track the numbers that it has processed, which may indicate that some requisitions have been lost. They can be tracked down by going to those departments to which certain ranges of document numbers were assigned, and seeing if they retained copies of the missing documents.

> **Tip:** If users are expected to fill out purchase requisitions on paper, rather than online, issue the forms in a two-part format, and encourage users to retain their copies. By doing so, the copy will still be available if the purchasing department misplaces its copy.

- *Verify against budget*. Most purchasing departments simply order what they are told to buy. However, it is possible to go a step further and compare the purchase request to the remaining amount of funding available in the budget. This takes extra time, and is only useful near the end of the fiscal year, where there may be little money left in the budget. However, in budget-constrained environments, such as governmental and non-profit situations, it may be an essential control.

2. Bidding
If the size of a purchase mandates that competitive bidding be used, there need to be controls over the process to ensure that it is completed fairly. In addition, these larger purchases may involve supplier contracts, which require a review to ensure that the contract terms are reasonable. The controls are:

- *Create bidding data trail*. There should be evidence that the purchasing staff engaged in bidding, thereby providing a barrier to suppliers giving kickbacks to the purchasing staff

in exchange for their orders. This data trail should include a list of who was contacted, copies of their bids, and the reason why a purchase order was awarded to the winner.

> **Tip:** Creating a bidding data trail is only useful if the purchasing staff knows it will be examined by someone, so schedule the internal audit team to review these documents on a regular basis.

- *Require legal review of contracts*. If the company is to engage in a contract with a supplier, have the legal staff review it to see if there are any shortcomings or risks to which the company may be subjected. This control usually only applies to larger contracts; otherwise, the legal department may be buried with reviews.
- *Use a contract checklist*. The legal staff should use a standard review checklist when examining proposed contracts with suppliers. This checklist is particularly important if contract reviews are handled by the purchasing staff, since they have less legal knowledge. Sample review items include the expiration date of the contract, prices, discounts, delivery dates, quality specifications, payment terms, warranty terms, and termination notification provisions.

3. Order Derivation

The purchase order itself is the best control point in the purchasing process, since it documents exactly what is being purchased and the terms under which the company agrees to make a purchase. It is also used in the receiving and accounting departments for additional controls. The controls related to the derivation of purchase orders are:

- *Generate purchase order*. The purchasing department issues a purchase order for every purchase made above a certain minimum dollar amount. By doing so, the purchasing staff is, in essence, approving all expenditures before they have been made, which may prevent some expenditures from ever occurring. This control may be strong enough to eliminate the need for a check signer.

> **Associated Policy:** If the company is going to mandate purchase orders for all (or most) purchases, an appropriate reinforcing policy would be: *No invoices shall be paid without a supporting purchase order.*

> **Tip:** In practice, it will be inordinately expensive to enforce the use of purchase orders for every acquisition. Instead, this control is more enforceable for larger purchases, with an automatic exemption for all purchases below a minimum dollar amount.

- *Match purchase order to purchase requisition*. The purchase order should match the item requested on the purchase requisition form. To ensure this, the department's copy of the purchase order should be compared and stapled to the requisition form.
- *Obtain purchasing manager approval*. If a purchase is for a very expensive item, it may be useful to involve the purchasing manager by requiring his or her signature on the purchasing authorization. This step is only going to help the control environment if the intent is to go back to the person requesting the item to make absolutely certain that they want to make the purchase.

4. Order Monitoring

An unfilled purchase order represents a future liability of the company, and so should be monitored closely. The following controls are used to ensure that this monitoring is conducted:

- *Retain a purchase order copy*. If the company does not store its purchase orders in a database, the purchasing department should retain a copy of each purchase order. This is useful for monitoring open purchase orders, as well as for tracking down orders that may have been lost by suppliers.
- *Review open purchase orders*. A major control is to tightly monitor the status of open purchase orders. This involves matching purchase orders against receiving reports to ascertain which orders are overdue, and following up on them. Though this is not a control over money (as is the case with most accounting controls) it *is* a control over operations, since missing materials can shut down a business.

> **Tip:** Be particularly careful to track the company's orders under a blanket purchase agreement, since the company may have agreed to a minimum purchase volume in exchange for a lower price per unit. The company should be made aware of an impending penalty payment to a supplier.

- *Close residual purchase orders*. The purchasing staff should periodically review the list of open purchase orders to see if any have been largely filled, with just a few residual units not shipped. Depending on the circumstances, it may make sense to close these purchase orders, thereby reducing the number of open items to monitor.

Alternative Purchasing Control Systems

In this section, we assemble a selection of the controls just described and apply them to different purchasing scenarios that involve bidding, not bidding, and a computerized system. While there are certain similarities in the controls used for each system, there are also crucial differences to consider when constructing your own system of controls.

Control System for Purchasing with Bids

This discussion addresses the controls for a traditional paper-based purchasing system where the purchasing staff obtains bids for more expensive items. The first control is to require a purchase requisition, since it provides sufficient documentation to prevent purchasing errors and should show the approval of the manager whose department will be charged for the items being acquired. It is only useful to prenumber the requisition forms if the purchasing department plans to track missing numbers; we will assume this is not the case in most situations, since the forms are not closely controlled and some may simply be thrown out by users. In a manual system, the purchasing staff is extremely unlikely to verify the remaining spendable balances against which purchases will be charged, since compiling this information can be time-consuming. Thus, the main control used to initiate a purchase in a manual environment is the requisition form.

If a proposed expenditure exceeds a certain size limit, the purchasing staff may engage in a bidding process. Since it is relatively easy to shortcut this process, the key control is to require documentation of a bidding data trail that encompasses a listing of who was contacted, copies of their bids, and documentation of the reason for the eventual award. This information is aggregated into a bidding package, which may be reviewed and approved by the purchasing manager or examined periodically by internal auditors. Larger bidding situations may involve

customized contracts, in which case there may be a need for a legal review that includes a contract checklist of key clauses that must be included.

The most important control in the entire purchasing process is the purchase order, since it is a legal authorization for a supplier to issue goods or services to the company. Once created, the purchasing staff should verify it against the original purchase requisition. If a purchase order is for a sufficiently large amount, it may also be necessary to obtain the approval signature of the purchasing manager.

After purchase orders have been issued, the department should retain a copy, so that it can follow up with suppliers and eventually close its records of any outstanding purchase orders for which there may still be some residual balances.

These controls are noted in the following control chart, where controls are clustered under the basic purchasing tasks.

Control System for Purchasing with Bids

```
┌─────────────────────────────────┐
│ 1. Purchase requisition         │
│   ┌─────────────────────────┐   │
│   │ Require purchase        │   │
│   │ requisition             │   │
│   └─────────────────────────┘   │
└─────────────────────────────────┘

┌─────────────────────────────────┐
│ 2. Bidding                      │
│   ┌─────────────────────────┐   │
│   │ Create bidding data     │   │
│   │ trail                   │   │
│   └─────────────────────────┘   │
│   ┌─────────────────────────┐   │
│   │ Require legal review of │   │
│   │ contracts               │   │
│   └─────────────────────────┘   │
│   ┌─────────────────────────┐   │
│   │ Use a contract checklist│   │
│   └─────────────────────────┘   │
└─────────────────────────────────┘

┌─────────────────────────────────┐
│ 3. Order derivation             │
│   ┌─────────────────────────┐   │
│   │ Generate purchase order │   │
│   └─────────────────────────┘   │
│   ┌─────────────────────────┐   │
│   │ Match purchase order to │   │
│   │ purchase requisition    │   │
│   └─────────────────────────┘   │
│   ┌─────────────────────────┐   │
│   │ Obtain purchasing       │   │
│   │ manager approval        │   │
│   └─────────────────────────┘   │
└─────────────────────────────────┘

┌─────────────────────────────────┐
│ 4. Order Monitoring             │
│   ┌─────────────────────────┐   │
│   │ Retain a purchase order │   │
│   │ copy                    │   │
│   └─────────────────────────┘   │
│   ┌─────────────────────────┐   │
│   │ Review open purchase    │   │
│   │ orders                  │   │
│   └─────────────────────────┘   │
│   ┌─────────────────────────┐   │
│   │ Close residual purchase │   │
│   │ orders                  │   │
│   └─────────────────────────┘   │
└─────────────────────────────────┘
```
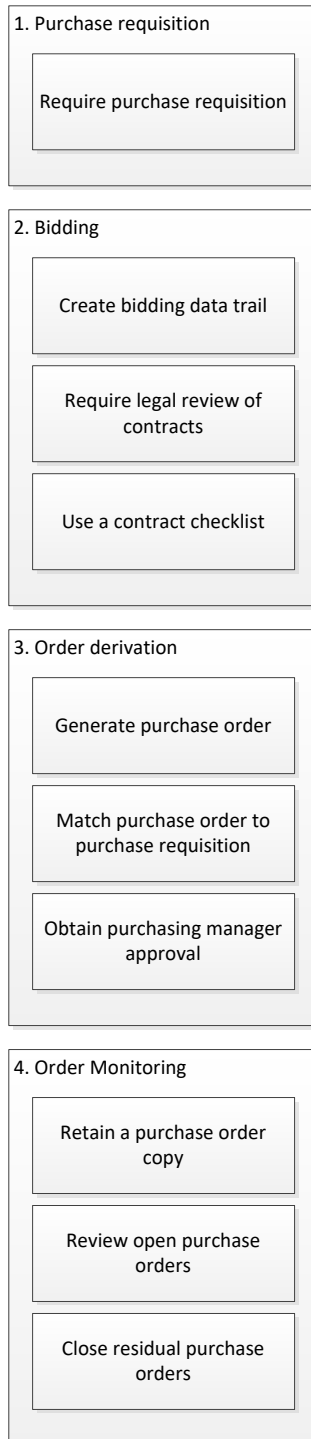
Control System for Purchasing without Bids

Many businesses do not bother with contacting suppliers for multiple bids, since it is time-consuming, results in having an excessively large number of suppliers, and places too much

emphasis on price. If so, the process flow skips a step, along with the associated controls. The resulting reduced set of controls appears in the following control chart.

Control System for Purchasing without Bids

1. Purchase requisition

Require purchase requisition

2. Order derivation

Generate purchase order

Match purchase order to purchase requisition

Obtain purchasing manager approval

3. Order Monitoring

Retain a purchase order copy

Review open purchase orders

Close residual purchase orders
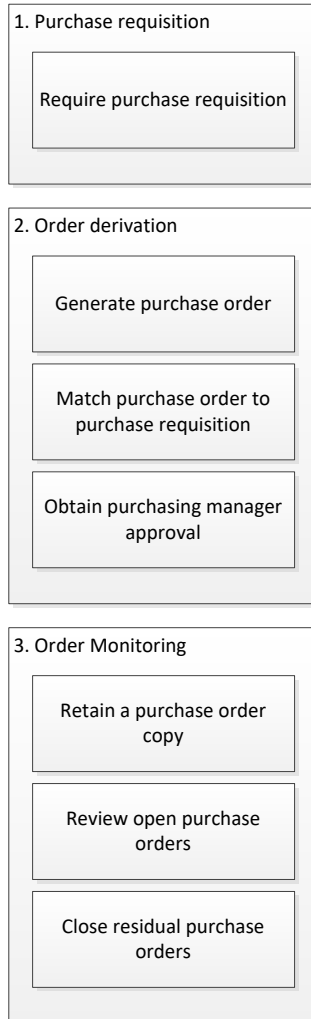
Controls for Purchasing with a Computerized System
When employees can order goods online and the purchasing staff manages its purchase orders online, the control environment changes somewhat. A purchase requisition is still needed, but there is no need for prenumbered forms, since the requisitions are handled through an online template. Also, the system can automatically compare requisitions against remaining budgeted funds and warn users if there will be a budget shortfall (this step may arise later in the process flow, once the purchasing staff enters prices into a purchase order).

The remaining controls are similar to those already noted, except that purchase order information is now available online, which makes it much more efficient to keep track of outstanding purchase orders. The resulting controls appear in the following control chart.

Controls for Purchasing with a Computerized System

1. Purchase requisition

> Require purchase requisition

> Verify against budget

2. Order derivation

> Generate purchase order

> Match purchase order to purchase requisition

> Obtain purchasing manager approval

3. Order Monitoring

> Review open purchase orders

> Close residual purchase orders
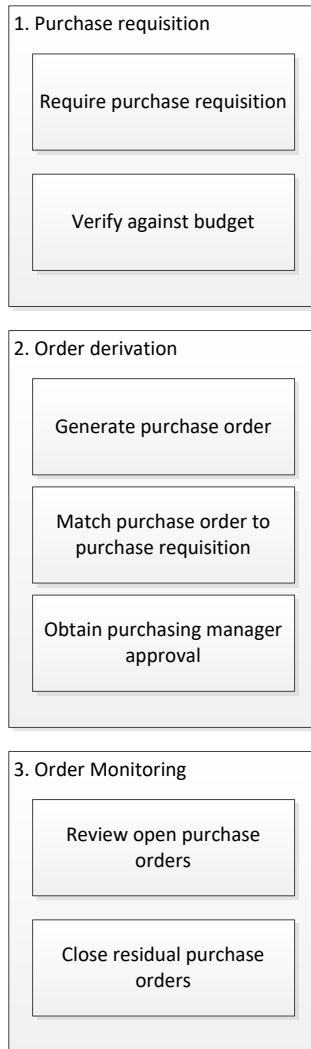
Additional Purchasing Controls – Fraud Related

There is a reasonable chance that fraud will occur in the purchasing area, since it involves the creation of a document that is a legal authorization to buy from a supplier. If someone can gain access to a company's purchase orders, they could order goods for which the company would be liable to pay suppliers. Accordingly, consider implementing the following controls to prevent or at least detect fraud:

- *Prenumber purchase orders*. If a company prepares purchase orders by hand and uses them as the primary authorization to pay suppliers, the purchase order document itself becomes quite valuable. Someone could fraudulently use a purchase order to order goods for themselves. To avoid this issue, prenumber all purchase orders and lock them up.

> **Tip:** In practice, the purchasing manager will probably assign a block of purchase orders to each purchasing staff person, who is then responsible for his or her forms. If so, the manager can track which purchase order numbers were assigned to each staff person. Then, if a purchase order is used improperly, you will know where the offending purchase order came from.

- *Password-protect purchasing software*. If the company creates purchase orders online and uses them as the primary authorization to pay suppliers, someone accessing the purchase order database can fraudulently order goods. To prevent this, use passwords to restrict access to the purchasing software.
- *Password-protect the vendor master file*. A supplier could offer a kickback to an employee for altering the terms of payment listed in the vendor master file, or an employee could create a fake supplier and use it to pay himself. These problems can be mitigated by using passwords to restrict access to the vendor master file.
- *Review the vendor master file change log.* There are a number of ways that the vendor master file can be altered for fraudulent purposes, such as changing a payment address to that of an employee, and then changing it back. To detect these changes, review the change log on a regular basis. Change logs are usually only available in higher-end purchasing software.
- *Review expense trends*. There may be an unusual blip in an expense line item in a particular month that was not caught by any of the in-process controls. Once investigated, the system can be modified to catch similar offending transactions in the future.

> **Tip:** Formulate a trailing 12-month income statement that shows the monthly results for each of the preceding 12 months for every expense account. This is the best source of information for conducting an expense trend analysis.

Additional Purchasing Controls – Periodic Actions

The following controls are useful for ensuring that purchase orders are used, that they are created correctly, and that the records supporting the purchasing system are properly maintained. They are not necessarily part of a specific process; instead, the purchasing staff schedules them as separate tasks. These controls are:

- *Reject deliveries without a purchase order*. In every business, there is always someone who places orders without going through the purchasing department. A possible control over this behavior is to require the receiving department to reject all deliveries made for which there is no authorizing purchase order.

> **Associated Policy:** The rejection of deliveries is sure to create a firestorm with whoever ordered the offending item, so be sure to create a supporting policy, such as: *All deliveries will be rejected if they are not accompanied by an authorizing purchase order.*

> **Tip:** The person who ordered an item that is rejected at the receiving dock will be furious. Consequently, it may make sense to first notify a senior manager of an item that is about to be rejected, thereby giving management forewarning before they are assaulted by the offending party. Also, if an item is clearly related to the cost of goods sold, the receiving department may be authorized to accept it irrespective of a missing purchase order, since it may be a rush order that is needed right now.

- *Review automated orders*. In many manufacturing operations, a materials planning system automatically generates purchase orders for raw materials, based on on-hand quantities and the production plan. The purchasing staff can review these automated orders before they are released, to ensure that record errors are not triggering orders for goods that the company does not really need.

> **Tip:** The review of automated orders is absolutely necessary when inventory record accuracy is low, since the basis for the orders may be incorrect. As record accuracy improves, the purchasing staff can confine itself to reviewing only the larger-value orders.

- *Use a supplier naming convention*. If the purchasing and accounts payable software interact, the purchasing staff may be responsible for setting up records in the vendor master file for new suppliers. If so, there should be a naming convention in place that makes it less likely to create a new record for an existing supplier. This reduces the number of records in the vendor master file.

> **Tip:** An example of a naming convention for creating a supplier identification number could include dropping "The" if that is the beginning of a company name, and then using the next six digits of the name, plus a three-digit number to uniquely identify all of the suppliers whose first six digits are the same. Thus, The Camera Store can be converted to CAMERA001, while The Camera Depot can be CAMERA002.

- *Consolidate the vendor master file*. In a larger business, it is entirely likely that multiple vendor files will be opened for a single supplier. This makes it difficult to assemble consolidated information for a single supplier, which is needed for spend management analysis. Consequently, the purchasing staff should engage in a periodic examination of the vendor master file to see if any records can be consolidated.
- *Designate suppliers as inactive*. If a supplier has not been used for some time or has been decertified, the purchasing department may want to set its status to inactive in the vendor master file. By doing so, the department will be much less likely to contact the supplier for bids or place orders with it. This is an especially important control if the company is concentrating its business with fewer suppliers in order to achieve volume discounts, and needs to stop doing business with peripheral suppliers.
- *Certify suppliers*. If a company has a quality program, it may engage in a periodic supplier certification review. This can encompass such factors as testing products against contract specifications, examining delivery dates, and visiting supplier facilities. There may also be a comparative ranking system, whereby low-scoring suppliers receive warnings and may be replaced.

Additional Accounting Policies

There are several supplemental accounting policies that were not mentioned earlier in association with specific controls. These policies are:

- *The purchasing staff shall be independent of the payables and receiving departments*. This policy is needed to prevent collusion in the creation and payment of fraudulent supplier invoices.
- *At least three bids shall be required for purchases exceeding $___*. This policy should be used with caution, for it can slow down the purchasing process to a great extent, even though it may achieve somewhat lower purchasing costs. Also, in a just-in-time environment where the focus is on reducing the number of suppliers, it may be irrelevant.
- *Professional services shall be bid every year*. This policy is designed to review competitive pricing for all types of professional services. Otherwise, relationships tend to continue for years, with pricing not being considered. The timing of the review could be extended, as long as there is an occasional review.

Summary

There are many controls related to the purchasing function, but this entire system of controls may not even be used if a business elects to ignore the purchasing function. For example, a smaller business that is not engaged in manufacturing may be quite comfortable letting an office clerk handle all purchases, and there may be little risk in doing so. Purchasing becomes a much larger liability if a business is engaged in the volume purchasing and sale of goods. In this latter case, a tightly organized purchasing department, augmented by a strong set of controls, may be the difference between recognizing profits or losses.

Some of the controls noted in this chapter, such as filling out requisition forms and verifying against the remaining budget, may seem like too much bureaucracy. However, they are in place for specific reasons, usually to ensure that the correct items are purchased and that spending limits are respected. Thus, when someone complains of purchasing bureaucracy, it may be useful to contemplate the increased level of disorganization that would exist without controls.

Chapter 8 – Review Questions

The review questions accompanying this course are designed to assist you in achieving the course learning objectives. The review section is not graded; do not submit it in place of your qualified assessment. While completing the review questions, it may be helpful to study any unfamiliar terms in the glossary in addition to course content. After completing the review questions, proceed to the review question answers and rationales.

15. A bidding trail is needed to:

    a. Show that an employee found the best price before completing a purchase requisition
    b. Show that an employee was hired at the lowest possible cost.
    c. Show that the purchasing staff engaged in bidding
    d. Ensure that purchase orders were fulfilled by suppliers

16. It is essential to review open purchase orders:

    a. To ensure that materials are received in time for operations to run smoothly
    b. To ensure that suppliers are billing the correct prices
    c. Since they are so closely linked to sales orders
    d. Within the first week of issuance

Chapter 9 – Accounts Payable Controls

Learning Objectives
After completing this section of the course, you will be able to:
- State the controls that can be assigned to supplier invoice recordation and payments.

Introduction
Accounts payable is an area in which a poorly-controlled department can lose money, as well as annoy those suppliers who are being paid late. In this chapter, we describe the control systems needed to remediate these issues. We will first address the three main tasks involved in accounts payable, then describe process-specific controls, and then show the control systems most likely to be needed for the following situations:
- Manual accounts payable system
- Computerized accounts payable system
- Electronic payments
- Evaluated receipts system

We conclude with a discussion of a number of additional accounts payable controls and related policies.

> **Related Podcast Episode:** Episode 13 of the Accounting Best Practices Podcast discusses accounts payable controls. It is available at: **accountingtools.com/podcasts** or **iTunes**

Accounts Payable Process Overview
Payables processing involves three primary activities, each of which may require controls, depending on the circumstances. The activities are:
1. Verify obligation to pay
2. Data entry
3. Payment

A narrative description of these three activities follows.

1. Verify Obligation to Pay
The accounts payable clerk wants to verify that a supplier invoice should be paid, that the goods or services associated with it have been received, and that the price listed on the supplier invoice is correct. This is usually done with *three-way matching*, which is a cross-comparison of the supplier invoice, purchase order, and receiving document. The three-way match is subject to error and delay, and so is usually restricted to only the more expensive supplier invoices.

An alternative to the three-way match is to load purchase orders into a computer database that is accessible at the receiving dock; the receiving staff can then update the purchase order record with the number of units actually received. The accounts payable staff then compares the supplier invoice to this record as its main verification step. An expanded version of this approach is for the accounting staff to also enter the supplier invoice into the system, which automatically matches all three types of information and issues a report noting any discrepancies. This feature is only found in the more expensive accounting systems.

Yet another way to verify the obligation to pay is the *evaluated receipts* system. This system involves sourcing all cost of goods sold items through a small number of suppliers, who are then authorized to deliver their raw materials on a just-in-time basis directly to the company's production lines. Once manufacturing has been completed, the company uses its *bills of material* (detailed records of what is supposed to be used to construct products) to determine what must have been delivered to the company, and pays based on this information and the price listed in its authorizing purchase order. The supplier does not have to send an invoice, and may be discouraged from doing so. Though this approach is extremely efficient, it also requires a very well-organized manufacturing and purchasing system.

2. Data Entry
The accounts payable clerk must enter the supplier invoice into the accounting system in order to pay it. In a basic computerized system, the clerk enters the essential identification information on the invoice, as well as the grand total to be paid. Or, if the company uses an automated three-way matching system, every line item on the invoice must be separately entered.

Another variation on data entry that is only used in high-volume operations is to scan incoming supplier invoices. The software is preconfigured to know where key information is located on each supplier's invoice, which the software then extracts and stores. This method is much more time-consuming to set up, and is likely to reject the invoices of suppliers whose invoice characteristics have not been entered into the system. Nonetheless, it is an extremely efficient data entry method for those larger firms willing to invest in it.

In addition to the methods just noted, there is the issue of when to engage in data entry. Some companies prefer to do so as soon as an invoice arrives, while others prefer to wait for invoices to be approved. In practice, those who wait for approval are likely to have approval exceptions for smaller or recurring invoices, which are entered at once; by doing so, they ensure that most payments will not be delayed by a slow approver.

3. Payment
Once supplier invoices have been entered in the accounting system, there are two ways to determine when they should be paid. The manual approach is to make note of due dates when they are initially entered into the system, and then store the invoices in folders that are organized by due date. This method can work surprisingly well, though there is a risk of misfiling invoices into the wrong due date categories. The alternative is to record the standard payment terms in the vendor master file for each supplier, and then be sure to record the correct invoice date in the system for each invoice. The system then uses the standard payment terms and invoice date to generate a list of which invoices are due for payment on which dates.

Once the payables clerk has decided which invoices to pay, there are still multiple alternatives for paying them. The first, and most common, is to pay by check. This involves printing a check, having it signed, and mailing it to the supplier (sometimes with a remittance advice from the supplier's invoice). The primary alternative is to pay a supplier by direct deposit, which usually involves either a manual payment transaction through the company's bank or the transfer of a payment file to the bank; in either case, the bank handles the direct deposit transaction, while the payables staff records the related invoices as having been paid. Less commonly, a company can

pay by wire transfer, which involves sending a wire transfer authorization to the bank or filling out an online wire authorization form on the bank's website. Wire transfers are not cost-effective, since wire fees are much higher than direct deposit fees.

A variation on the payment concept is the use of procurement cards. They are generally paid with a check; the key point is that a large number of small purchases are aggregated into a single large payment, which greatly improves payables efficiency. See the Procurement Card Controls chapter for more information.

The general flow of these three accounts payable steps, including the associated paperwork, is noted in the following flowchart.

Accounts Payable Process Flow
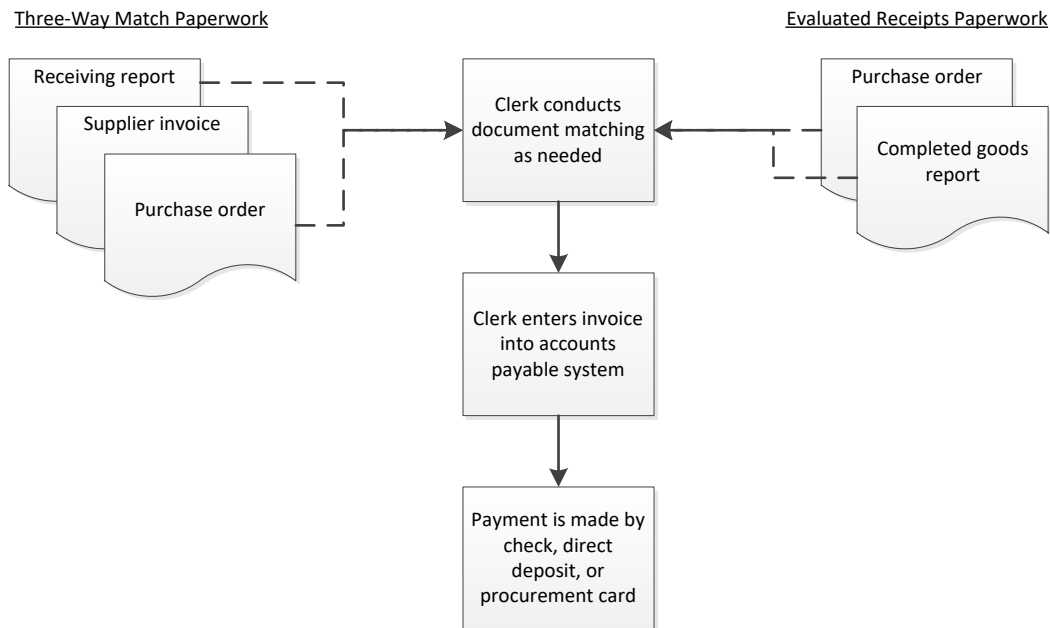
In-Process Accounts Payable Controls
In this section, we cover the controls that can be imposed on the core accounts payable processes. In addition, refer to the Additional Payables Controls sections for other controls that are positioned outside of the basic accounts payable transactions.

1. Verify Obligation to Pay
The verification of obligation to pay can be accomplished through one of several possible controls. They are:
- *Invoice approval.* The person in a position to authorize payment signifies his or her approval of a supplier invoice. However, this is actually a relatively weak control if the approver only sees the supplier invoice, since there is no way to tell if the goods or services were received, or if the prices being charged were what the company originally agreed to. The approver may also want to know which general ledger account will be charged. Consequently, it is better to have the payables staff first assemble the supplier

invoice, authorizing purchase order, and receiving documentation into a packet, then stamp the invoice with a signature block that includes the account number to be charged, and *then* have the approver review it. This approach gives reviewers a *very* complete set of information to work with.

> **Associated Policy:** If the company is going to mandate invoice approvals, an appropriate reinforcing policy would be: *No invoices shall be paid without prior supervisory approval.*

> **Tip:** Approvers are busy, and so have a bad habit of only giving supplier invoices a perfunctory review before approving them. To prevent this, the accounts payable manager can set up appointments with each approver, bring the invoices to them, and discuss the invoices with them. This approach also ensures that every invoice will be returned promptly.

> **Tip:** If invoices are sent out for approvals prior to being entered in the payable system, maintain a log of the invoices that are out for approval, and cross them off when they are eventually returned. This makes it easier to determine which invoices have *not* been returned.

- *Purchase order approval*. The purchasing department must issue a purchase order for every purchase made. By doing so, the purchasing staff is, in essence, approving all expenditures before they have been made, which may prevent some expenditures from ever occurring. Since this control entails extensive work by the purchasing staff, they will likely ask employees to request items on a formal purchase requisition form.

> **Associated Policy:** If the company is going to mandate purchase orders for all (or most) purchases, an appropriate reinforcing policy would be: *No invoices shall be paid without a supporting purchase order.*

> **Tip:** In practice, it will be inordinately expensive to enforce the use of purchase orders for everything. Instead, this control is more enforceable for larger purchases, with an automatic exemption for all purchases below a minimum dollar amount.

- *Complete a three-way match*. The payables staff matches the supplier invoice to the related purchase order and proof of receipt before authorizing payment. This approach supersedes the need for individual invoice approval, since approval is based on the purchase order instead. It is also better than approving only based on the purchase order, since it also verifies receipt of the goods. However, it is also painfully slow and can break down if there is missing paperwork.

> **Tip:** Always allow the payables staff some margin for which invoices can be approved under the three-way match. For example, the price on an invoice might be acceptable if it is within 0.5% of the amount on the purchase order, while the received quantity is acceptable if it is within a similar margin. Without these margins, very few invoices would ever be paid. Also, there should be exemptions from three-way matching, such as tax payments, royalty payments, insurance, and benefit payments, where the required paperwork may not be available.

> **Tip:** It seems to be easiest for receiving reports to go astray, so consider having them prenumbered, which helps to determine which reports are missing.

- *Manual duplicate payment search*. As will be described shortly, a computerized payables system conducts an automatic search for duplicate invoice numbers. This is a much more difficult endeavor in an entirely manual accounting system. In this case, the payables clerk can search through the vendor file and unpaid invoices file to see if an invoice just received from a supplier has already been paid. In many situations, the volume of incoming supplier invoices makes this so difficult that the payable staff abandons any attempt to identify duplicate invoices, and simply accepts that it will occasionally pay for such items.
- *Verify purchase order number*. In the evaluated receipts system, there is no supplier invoice. Instead, the company sends a purchase order number to each supplier, which they include on their packing slips when shipping goods to the company. If there is no purchase order number, the delivery is rejected. Thus, verifying an obligation to pay really involves making sure that purchase orders are issued, and that receipts have identifying purchase order numbers that have not expired.

2. Data Entry

There are several ways to ensure that all supplier invoices have been entered in the accounts payable system, though these controls have varying degrees of success. The controls are:

- *Record after approval*. This control forces the accounts payable staff to verify the approval of every invoice before entering it into the system.

> **Associated Policy:** A policy is needed to ensure that the payables staff does not enter supplier invoices prior to approval, so an appropriate reinforcing policy would be: *No invoices shall be entered in the payables system without prior approval, except for invoices of less than $_____ and recurring or utility invoices.*

> **Tip:** This control can be an expensive one, since some invoices will inevitably not be approved in time to be paid by their due dates. To avoid late penalties, use automatic approvals of smaller and recurring invoices, and have several alternate approvers available if the primary approvers are not available.

- *Record prior to approval*. This control places greater priority on paying suppliers than it does on obtaining authorizations to pay, since every invoice received is recorded in the payables system at once. This control works best where purchase orders have already been used to authorize a purchase.

> **Tip:** When recording supplier invoices in advance, consider using *negative approvals*. This means that approvers receive a copy of each invoice, but only contact the payables staff if they *do not* approve an invoice. This largely eliminates the amount of feedback that the payables staff can expect from authorizers.

- *Adopt an invoice numbering guideline*. Perhaps the largest problem in the area of payables data entry is duplicate payments. This would not appear to be a problem, since most companies use accounting software that automatically detects duplicate invoices and prevents duplicate payments. However, there can be inconsistency in how invoice numbers are recorded. For example, do you record invoice number 0000078234 with the leading zeros or without them? If the same invoice is presented to the payables staff twice, and it is recorded as 0000078234 one time and 78234 the next time, the system will not flag them as being duplicate invoices. The same problem arises with dashes in an

invoice number; an invoice number of 1234-999 could be recorded as 1234-999 or as 1234999.

A simple control over the duplicate invoice problem is a one-page description of how invoice numbers are to be recorded, which is to be posted prominently next to the computer of every accounts payable data entry person for easy reference. A sample statement follows.

Invoice Number Policy

Leading zeros: Always delete all leading zeros from an invoice number.

For example: Record 0000078234 as 78234

Dashes: Always delete all dashes from an invoice number.

For example: Record 1234-999 as 1234999

No invoice number: Enter the invoice date as a six-digit number.

For example: Enter an invoice dated July 9, 2015 as 070915

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3. Payment

The bulk of the controls noted below pertain to payment by check, since that is still the predominant form of payment. Several controls near the bottom of the list are targeted at electronic payments. The controls are:

- *Split check printing and signing*. One person should prepare checks, and a different person should sign them. By doing so, there is a cross-check on the issuance of cash.
- *Store all checks in a locked location*. Unused check stock should *always* be stored in a locked location. Otherwise, checks can be stolen and fraudulently filled out and cashed. This means that any signature plates or stamps should also be stored in a locked location.

> **Tip:** If there is a signature stamp or plate, store it in a different locked location from the check stock, and keep the keys to the two locations in different spots. Ideally, different people should be responsible for the check stock and the signature plate. This makes it more difficult for someone to obtain both and generate valid-looking check payments.

- *Secure check-printing equipment.* Some printers are only used for check printing. If so, keep them in a locked location so that no one can print checks and have the integrated signature plate automatically sign the checks.
- *Track the sequence of check numbers used*. Maintain a log in which are listed the range of check numbers used during a check run. This is useful for determining if any checks in storage might be missing. This log should not be kept with the stored checks, since someone could steal the log at the same time they steal checks.
- *Issue checks in numerical order*. This is not actually a control, but rather a means of ensuring that there are few gaps in the sequence of check numbers that need to be investigated. From a practical perspective, checks are nearly always used in batches, so they will always be issued in numerical order.

- *Require manual check signing*. A company can require that all checks be signed. This is actually a relatively weak control, since few check signers delve into why checks are being issued, and rarely question the amounts paid. If a company chooses to use a signature plate or stamp instead, it is much more important to have a strong purchase order system; the purchasing staff becomes the de facto approvers of invoices by issuing purchase orders earlier in the payables process flow.

> **Tip:** If the company requires manual check signing, do everything possible to strengthen the control. This means assembling a voucher package for each check that the check signer can review, and having a payables person sit with the check signer to answer questions during signing sessions.

- *Require an additional check signer*. If the amount of a check exceeds a certain amount, require a second check signer. This control supposedly gives multiple senior-level people the chance to stop making a payment. In reality, it is more likely to only introduce another step into the payment process without really strengthening the control environment.
- *Stamp invoices "paid"*. In a purely manual payables environment, there is a risk of paying an invoice more than once, so a reasonable control is to stamp each paid invoice, or even perforate it with a "paid" stamp. This control is less necessary (if at all) in a computerized system, which automatically tracks which invoices have been paid.

> **Tip:** If the decision is made not to use a "paid" stamp in a computerized environment, be sure to install a consistent procedure for assigning an invoice number to those invoices that are not numbered. Otherwise, the copies of the same invoice could be assigned different invoice numbers and then be paid.

- *Lock up undistributed checks*. If the company does not distribute checks at once, they should be stored in a locked location. Otherwise, there is a risk of theft, with the person stealing the checks modifying them sufficiently to cash them.
- *Use positive pay*. Positive pay is a program under which a company sends a file containing its check payment information to its bank; if a check is presented for payment and it is not on the list of checks issued by the company, the bank rejects it. This can eliminate check fraud, though there is some question of whether it is more beneficial to the bank (which could be liable for accepting fraudulent checks) or the company.

> **Tip:** It is easy to forget to notify the bank of check payments, especially manual checks that are created outside of the normal check printing process. Therefore, have an iron-clad bank notification system in place before enacting positive pay. It may help to run positive pay on a test basis for a few months to see how many check notifications were not made, and what caused them.

- *Initiate banking transactions from a dedicated computer*. It is possible for someone to use keystroke logging software to detect the user identification and password information that a business uses to authorize direct deposit and wire transfer information. To reduce the risk, set up a separate computer that is only used to initiate transactions with the bank. This reduces the risk that keystroke logging software might be inadvertently downloaded onto the machine from an email or other transaction.
- *Pay from a separate account*. There is a risk that someone could use an ACH debit transaction to move funds out of a company's bank account. To reduce this risk, only

shift sufficient funds into a checking account to cover the amount of outstanding checks, ACH payments, and wire transfers that have not yet cleared the bank.

> **Associated Policy:** The accounting staff will probably keep more cash in the checking account than necessary, since continually funding the account requires extra work. To reinforce the need for minimized account funding, use this policy: *The checking account shall only be funded to meet current payment obligations.*

- *Password-protect the direct deposit file*. Some companies accumulate bank account information for their supplier payments in a computer file, while others may access it online in their bank's systems. In either case, the file should be password protected to prevent tampering with the accounts. Also, the password should be changed regularly, and certainly after anyone with access to the file has left the company.
- *Different person verifies or approves wire transfers*. When a company authorizes a wire transfer, one person issues the instructions to the bank, and a different person verifies or approves the transaction.

> **Tip:** If a different person is to verify or approve each wire transfer, set up the email address of the verifying person in the confirmation contact list in the bank's records, so that notifications are automatically sent to that person.

> **Tip:** Direct deposit and wire transfer payments are frequently made outside of the accounts payable system, which means that someone has to manually record these payments in the payables system. If they forget to do so, there is a risk that these items will be paid again, or paid by check. Consequently, be sure to set up a default payment type for each supplier in the vendor master file, and stick to that payment type. Treat any request for a different type of payment as a policy violation, which requires extra approvals.

Alternative Accounts Payable Control Systems

In this section, we assemble a selection of the controls just described and apply them to different accounts payable scenarios involving a manual system, a computerized system, electronic payments, and an evaluated receipts system. While there are certain similarities in the controls used for each system, there are also crucial differences to consider when constructing your own system of controls.

Control System for Manual Accounts Payable

In a manual accounts payable system, it is theoretically possible to use any of the three approval methods – by invoice, purchase order, or three-way match. Realistically, a company running a manual system probably is not using purchase orders, so the most likely control over verifying the obligation to pay is invoice approval. In the data entry area, invoices can be recorded in the system before or after invoice approval. Generally, recording invoices before approval makes more sense, since invoices can be lost on the desks of those supervisors assigned to approve them.

In a manual system, it certainly makes sense to lock up all unused checks. It is a good idea to track the sequence of check numbers, but if there are few people who could potentially steal checks, this control could be avoided. It is very likely that manual check signing will be needed in this environment, especially if purchase orders are not being generated. Finally, in the absence

of a computer system that can determine when invoices have been paid, stamp or perforate all paid invoices with the word "paid".

These controls are noted in the following control chart, where controls are clustered under the basic payables processing tasks.

Control System for Manual Accounts Payable

1. Verify obligation to pay

> Invoice approval - or

> Purchase order approval - or

> Three-way match

> Manual duplicate payment search

2. Data entry

> Record after approval - or

> Record prior to approval

3. Payment

> Store checks in locked location

> Track check number sequence

> Require manual check signing

> Stamp invoices "paid"
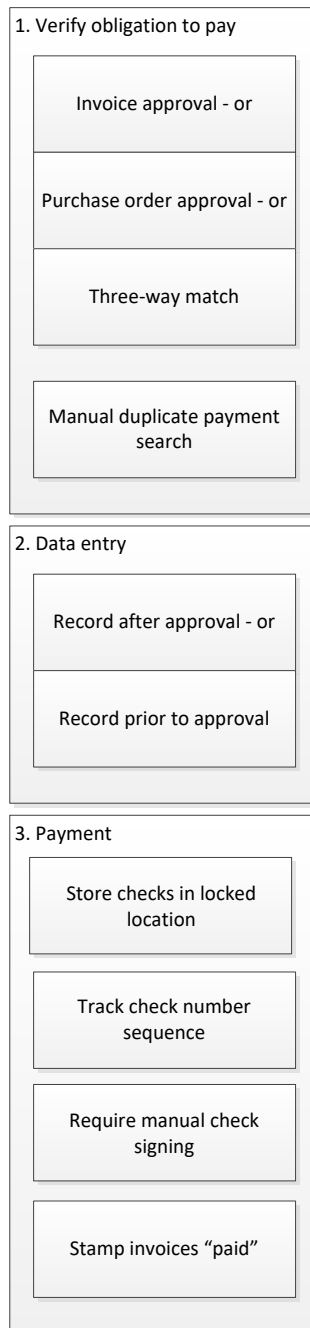
Control System for Computerized Accounts Payable
When accounts payable transactions are recorded in a computer system, it is easier to match invoices to the authorizing purchase orders, as well as to conduct three-way matching. Thus, all three verification to pay methods are available to the user.

The chief difference between the data entry for manual and computerized environments is that an invoice numbering guideline is much more necessary in a computerized system, where the software can automatically detect duplicate supplier invoices.

The payment step changes somewhat in a computerized system. We assume that the business is larger, so it is more likely that there are enough people in the accounting department to justify splitting the check printing and signing activities, thereby providing a cross-check. Also, with the software generating a list of checks issued, it is easier to subscribe to the bank's positive pay system (though it is not necessary to do so). Finally, it is less necessary to stamp invoices as "paid," since this information is tracked by the software.

These controls are noted in the following control chart, where controls are clustered under the basic payables processing tasks.

Control System for Computerized Accounts Payable

1. Verify obligation to pay

> Invoice approval - or

> Purchase order approval - or

> Three-way match

2. Data entry

> Record after approval - or

> Record prior to approval

> Use invoice numbering guideline

3. Payment

> Store checks in locked location

> Track check number sequence

> Split check printing and signing

> Use positive pay
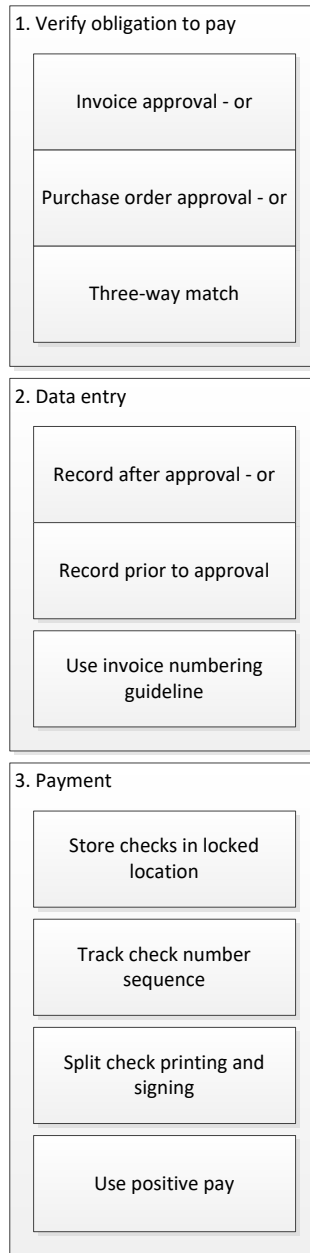
It is much more likely in a computerized payables environment that a company will take advantage of electronic payments, so we include a second version of the controls used for payables payments. The central issues regarding these types of payments are keeping the transactions as segregated as possible and ensuring that a second person approves the transactions. The risk of loss is quite high when electronic payments are used, so the level of control must be correspondingly rigorous.

Control System for Electronic Payments

```
┌─────────────────────────────────────┐
│ 3. Payment                           │
│   ┌───────────────────────────────┐  │
│   │  Initiate transactions from   │  │
│   │      dedicated computer       │  │
│   └───────────────────────────────┘  │
│                                      │
│   ┌───────────────────────────────┐  │
│   │  Pay from a separate account  │  │
│   └───────────────────────────────┘  │
│                                      │
│   ┌───────────────────────────────┐  │
│   │  Password protect the direct  │  │
│   │         deposit file          │  │
│   └───────────────────────────────┘  │
│                                      │
│   ┌───────────────────────────────┐  │
│   │  Second person approves       │  │
│   │       wire transfers          │  │
│   └───────────────────────────────┘  │
└─────────────────────────────────────┘
```
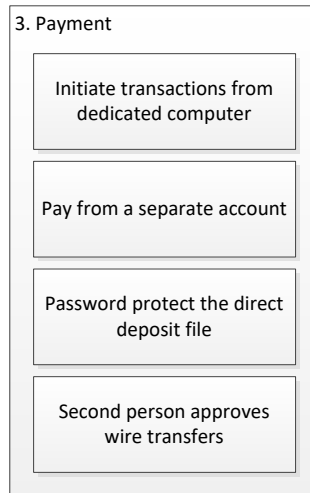
Control System for Evaluated Receipts

The evaluated receipts system is designed to pay without a supplier invoice, instead using a combination of purchase order pricing information and unit quantities from receiving or production records to compile what the invoice should contain. The result is a uniquely sparse control chart, as can be seen below. Verifying the obligation to pay is based on issuing a purchase order and then verifying that the purchase order number is referenced in all deliveries to the company. There may not be any data entry controls if payments are made from production records, since there is no data to enter (other than the final production numbers). Payments are nearly always automated, using direct deposit, so a reduced set of controls are noted that relate solely to direct deposit transactions.

These controls are noted in the following control chart, where controls are clustered under the basic payables processing tasks.

Control System for Evaluated Receipts System

1. Verify obligation to pay

Issue purchase order

Verify purchase order number

2. Data entry

None

3. Payment

Initiate transactions from dedicated computer

Pay from a separate account

Password protect the direct deposit file
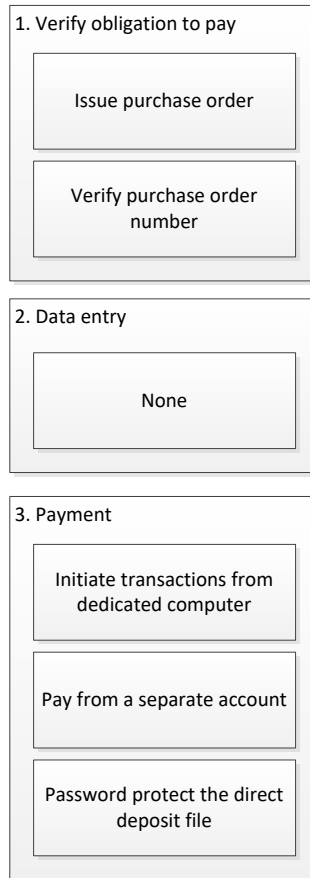
Additional Payables Controls – Trend Analysis

Some controls are not directly related to any of the process flows noted earlier. Instead, they are more of the investigative variety, and so are used to spot possible control problems after the fact. These controls include:

- *Review expense trends*. There may be an unusual blip in an expense line item in a particular month that was not caught by any of the in-process controls. Once investigated, the system can be modified to catch similar offending transactions in the future.

> **Tip:** Formulate a trailing 12-month income statement that shows the monthly results for each of the preceding 12 months for every expense account. This is the best source of information for conducting an expense trend analysis.

- *Review supplier trends*. As just noted for the review of expense trends, create the same report at the supplier level for each of the past 12 months. It may reveal billings from suppliers who had otherwise been inactive. This can indicate that an employee used one of the inactive accounts to fabricate an invoice and submit it to the company for payment.
- *Hire a payment analysis firm*. Some consulting firms specialize in finding duplicate payments. Hire one of these firms occasionally to look for such payments. The key point

in these reviews is to determine the reasons why such payments were made, and install controls that will keep them from happening again.

While these controls may be useful for spotting larger anomalies, they are not of much use if there are discerning perpetrators on the premises. Knowing that these controls exist, someone could hide a series of improper payments by recording them in accounts having large expense balances, or by incurring relatively small charges over a long period of time.

Additional Payables Controls – Fraud Related

There is a reasonable chance that fraud will occur in the payables area, since it involves the disbursement of cash. Accordingly, consider implementing the following controls to prevent or at least detect fraud:

- *Run a credit report on new suppliers*. Someone within the payables department could create a vendor record in order to pay fraudulent invoices to it, with the payments being routed back to the employee. It is possible to detect this by running a credit report on all new suppliers to verify their existence. From a practical perspective, this is an expensive way to locate potentially fraudulent activity.
- *Search for purchase authorization avoidance*. Run a search through the payables records to see if the company received multiple invoices from a supplier during a period. If so, investigate to see if the invoices should have been aggregated into a single invoice for a large-dollar item that would otherwise have required a higher level of purchase authorization. This indicates possible chicanery within the company to obtain assets.
- *Match supplier to employee addresses*. An employee may be directing supplier payments to his or her home address, or may own a supplier that does business with the company. To detect these payments, periodically run a comparison of employee addresses to supplier addresses to see if there are any matches. From a practical perspective, a reasonably knowledgeable employee will simply set up a post office box and have payments sent there, so this is not an overly productive control.
- *Review vendor master file change log*. An employee could access the vendor master file, change a payment address to his or her home address, then cut a check that is mailed to that address, and then re-enter the file and switch the address back to the supplier's real address. This can be detected by periodically reviewing the change log for the vendor master file. Less-expensive accounting systems may not have this feature.
- *Review direct deposit change log*. Some high-end accounting systems store supplier direct deposit information in a separate file. If so, conduct a periodic review to see if anyone has altered the direct deposit information. This is one of the easier ways to route money into an account owned by an employee.
- *Set check printing to avoid blanks*. Set the check printing methodology in the accounting software to insert characters into the blank spaces on the amount and payee lines of checks. This makes it more difficult for someone to fraudulently alter checks.
- *Make check reproduction difficult*. There are a large number of anti-fraud features built into check stock that make them more difficult to reproduce. This can hardly be called a control anymore, since many of the features are provided automatically by check stock printers.

- *Destroy check stock for inactive accounts*. If a checking account is no longer being used, shift out any residual funds, close the account, and shred any remaining check stock. Otherwise, someone could clear out any remaining funds with one of the unused checks.

> **Tip:** It is especially common to eliminate bank accounts following an acquisition, so include a work step in the acquisition integration procedure to close the accounts and shred the related check stock.

- *Reconcile the checking account daily*. It is extremely useful to conduct a complete account reconciliation of the checking account every day. By doing so, any problems with fraudulent checks will be immediately apparent.

> **Tip:** Daily reconciliations are possible as long as the bank makes detailed account information available online. If so, the procedure is identical to the month-end bank reconciliation.

- *Install a debit block*. Someone can create an ACH debit transaction that removes funds from the company's bank account. It is possible to set up a debit block with the bank that prevents ACH debits from being enacted. Under this approach, the company must notify the bank when it authorizes a debit from a specific supplier. Also, it may make sense to set a daily cumulative limit for ACH debits; this keeps even an approved supplier from withdrawing an inordinate amount from the bank account.

Additional Payables Controls – Periodic Actions

The following controls are useful for keeping costs down or making payables operations more efficient. They are not necessarily part of a specific process; instead, the payables staff schedules them as separate tasks. These controls are:

- *Investigate credits*. The aged accounts payable report almost always contains a plethora of residual supplier credits or credits caused by overpayments. The payables staff should periodically review and resolve these items, either by offsetting them against payables not yet paid, or by obtaining reimbursement from suppliers. This can be considered a control, since it involves the prevention of funds being lost through inaction.
- *Investigate old unpaid payables*. The accounts payable manager and controller should conduct a monthly review of the aged accounts payable report to determine the nature of any clearly overdue supplier invoices, and decide what to do with them.
- *Match aged payables report to general ledger*. The total of the aged accounts payable report should match the related account balance at the end of the month. A reasonable control is to see if there is a difference between these two numbers, and to reconcile the difference.
- *Investigate missing matching documents*. If a company is using three-way matching and some of the supporting documentation has not appeared, a periodic investigation should be focused on finding these documents or finding a way around the situation, in order to pay suppliers on a timely basis.
- *Match returns log to credits*. If the company routinely returns goods to its suppliers, maintain a log of returned items, and match it against credits received from the suppliers. This will likely call for follow-up with those suppliers that are laggards in providing credits.

- *Investigate early payment discounts*. There should be an occasional review of early payment discounts to see if the cost-effective ones were taken. If a number of early payment discounts are being missed, this may call for an examination of the underlying system that brings discounts to the attention of the payables staff.
- *Maintain a voided checks log*. By documenting every check that has been voided, it is easier to determine which checks are still outstanding for bank reconciliation purposes, as well as to track down missing checks. This control is not necessary in a computerized environment, since the accounting system keeps track of voided checks.

> **Tip:** A check that has been voided in the accounting system could still be stolen and cashed. Accordingly, buy a "void" or "cancelled" stamp and use it to mark every voided check.

- *Review for duplicate supplier records*. It is very easy to accidentally create multiple records for the same supplier, which causes problems in linking invoices to the correct supplier record. Consequently, there should be a periodic review of the vendor master file for duplicate supplier records. Any duplicates should be merged into a single supplier record.

> **Tip:** It may be useful to adopt a standard naming convention for all new suppliers, so that an existing supplier name may appear in the accounting system when someone attempts to enter a new vendor code for the same supplier. For example, the naming convention might be the first six digits of a supplier's name, followed by a sequential number. Thus, the vendor code for Jones Corporation would be JONESC001.

- *Assign inactive status to suppliers*. When suppliers are no longer used, set their status in the vendor master file to "inactive." In most accounting systems, this will prevent any additional payments from being made to them. This can be a quarterly or annual task.
- *Audit recurring payments*. The payables system may be set up to continually issue the same payment amount to the same supplier on the same date of every month. To guard against paying these recurring amounts for an excessive period of time, conduct an occasional review of all recurring payments to verify that they should still be paid.

Additional Accounting Policies

There are several supplemental accounting policies that were not mentioned earlier in association with specific controls. These policies are:

- *The payables staff shall be independent of the purchasing and receiving departments*. This policy is needed to prevent collusion in the creation and payment of fraudulent supplier invoices.
- *Payments from invoice copies require manager approval*. When a payment does not arrive on time, the supplier typically makes a photocopy of its copy of an invoice and forwards it for payment. Thus, a request to pay from a copy is a near-certain sign that there are at least two copies of the invoice floating around in the company, which increases the risk of a duplicate payment. By requiring manager approval for such invoices, it is hoped that the manager will examine the payables records to see if the original version was already paid.

- *No payments shall be made from supplier statements*. A statement of unpaid invoices does not provide sufficient information for a payment, so the underlying supplier invoice must be obtained before there is sufficient evidence to justify a payment.
- *Do not make checks payable to "bearer" or "cash"*. This policy may occasionally be breached in cases where a supplier actually asks for this type of payee on a check. Nonetheless, allowable situations should be extremely rare.
- *Do not sign blank checks*. It is easy for a fraud-minded employee to get around this policy if the company uses a signature plate or stamp, so it tends to serve more as a general admonition to check signers. It could, for example, be included in a short training class given to new check signers.
- *Early payment discounts shall be taken when the effective interest rate exceeds the corporate cost of capital*. This policy may be too strict if a company has little excess cash, in which case the treasurer should be allowed to override it.
- *Manual checks are only to be used in emergencies*. It is much more time-consuming to create checks manually. In addition, the accounting staff may forget to record these checks in the accounting system, or make a positive pay notification to the bank. Consequently, all check printing should be channeled through the check printing function of the accounting software. This policy can be enforced by charging requesters an inter-company fee for creating a manual check.

> **Tip:** An additional problem with manual checks is that they are sometimes for entities that are not even listed as approved suppliers in the company's payment system. A policy to only issue manual checks to approved suppliers will further reduce the number of manual check issuances.

- *Payment terms shall be followed*. This policy is less about an overly obvious mandate to pay as per the terms negotiated with suppliers, and more about requiring controller approval in order to accelerate a payment.
- *A stop payment shall be issued when there is no physical evidence of a voided check*. This policy is useful in situations where the company is intent on keeping a complete record of all voided checks, such as a file containing every voided check. In cases where the checks were sent to suppliers and then voided, file a copy of the bank's stop payment confirmation.
- *Check recipients shall be contacted after 90 days if checks have not been cashed*. This policy is more useful from the perspective of the bank reconciliation, since it clears out older checks that are still outstanding. A common outcome of this policy is an increase in the number of voided checks and the issuance of replacement checks.
- *Check signers shall be disallowed immediately following departure*. As soon as an employee who is authorized to sign checks leaves the firm, contact the bank to remove them from the authorized check signer list. This also applies to the wire transfer approval list.

Summary

Clearly, there are many controls that can be applied to the accounts payable process. However, an overly cautious controller may implement every possible control, only to see the efficiency of the department decline precipitously. The solution is a combination of two items:

- *Exclusions*. Adopt a reduced set of controls for lower-cost purchases. This usually means shifting to procurement cards (see the Procurement Card Controls chapter) for low-cost items.
- *Controls based on risk and probability*. Examine the payables process from the perspective of reducing high-risk and high-probability issues, and only implement controls for those items. Conversely, it usually does not make much sense to install controls to mitigate potential problems that are not only unlikely, but which will only result in small losses.

This chapter does not address all aspects of accounts payable. In the next two chapters, we also cover employee expense reports and procurement cards.

Chapter 9 – Review Questions

The review questions accompanying this course are designed to assist you in achieving the course learning objectives. The review section is not graded; do not submit it in place of your qualified assessment. While completing the review questions, it may be helpful to study any unfamiliar terms in the glossary in addition to course content. After completing the review questions, proceed to the review question answers and rationales.

17.   Three-way matching is designed to:

    a. Involve at least three approvers in each supplier payment
    b. Ensure that there is sufficient funding for a prospective purchase
    c. Verify that a supplier invoice is authorized for payment and that the billed items were received
    d. Ensure that a check should be paid

18.   An invoice numbering guideline is useful when:

    a. There is an early payment discount involved
    b. There are unique invoice numbers
    c. Invoice numbers have trailing zeroes
    d. Invoice numbers have leading zeroes

Chapter 10 – Expense Report Controls

Learning Objectives
After completing this section of the course, you will be able to:
- Specify the controls that can be inserted into the processing of employee expense reports.

Introduction
Expense reports are submitted by employees in order to be reimbursed for expenses that they incurred on behalf of their company. Expense reports are handled in a different chapter from accounts payable, because they are so different from the normal supplier invoices; there is no authorizing purchase order, there is no receiving report, and there is no three-way match. In addition, there can be an immense amount of related paperwork that comes with each expense report. These differences call for an alternative set of controls.

In this chapter, we address two of the three main steps involved in expense report processing, describe process-specific controls, and then show the control systems most likely to be needed for the following situations:
- Manual expense report submissions
- Automated expense report submissions

We conclude with a discussion of several additional expense report controls and related policies.

> **Related Podcast Episode:** Episode 6 of the Accounting Best Practices Podcast discusses expense report controls. It is available at: **accountingtools.com/podcasts** or **iTunes**

Expense Report Process Overview
Expense report processing involves three primary activities, all of which are likely to require controls. The activities are:
1. Expense report submission
2. Expense report examination
3. Employee payment

The final step, employee payment, is addressed in the Accounts Payable Controls chapter. A narrative description of the first two steps follows.

1. Expense Report Submission
The most common submission process for expense reports is for employees to fill out an Excel spreadsheet template that a company uses as its expense report form, attach all related receipts, have a supervisor review and approve the reports, and then submit them to the accounts payable staff for further processing. This is a time consuming chore for those employees who travel frequently, but is largely unavoidable when a third party (the payables staff) must have an organized document from which to enter expense information into the accounts payable system.

A less common approach (due to the cost) is to set up a front-end to the accounting system that allows employees to enter their own expense reports into the system through an online form. There are several of these systems available through third-party suppliers, or a company may

choose to construct its own system. In either case, employees take over the data entry chore from the accounts payable staff. Because of the change in roles, there is no longer a need for employees to create a formal expense report – the system organizes the expense report for them, based on their submissions to it. An automated system can be configured to require or request scanned receipts to support the reimbursement amounts being claimed, though this requires the use of scanning equipment by employees.

2. Expense Report Examination

The second major step in expense report processing is the examination of the reports to see if they are clerically accurate and contain valid expenses. This review can come either prior to or after entering the reports into the accounting system.

Ascertaining clerical accuracy can be a surprisingly large issue in those companies where an Excel template is being used to construct expense reports, since employees may insert rows into the template and not adjust the report totals to encompass the additional rows. This is not a concern at all when employees are entering their information into an online form, since the system is not relying upon a potentially buggy spreadsheet.

A second reason for examining reports is to ensure that they contain valid expenses. This can involve 100% checking of all reports, or the auditing of a selection of them. In either case, the reviewer examines the reports to verify that every reimbursement claimed falls within the company's guidelines for reimbursement, and that there is adequate supporting documentation. If the company uses an automated system, the computer can test the submissions against the company's travel and entertainment rules, thereby reducing the amount of cross-checking to be done by the payables staff.

Payments to employees are handled through the normal payments process already documented in the Accounts Payable Controls chapter.

The general flow of these expense report steps, including the associated paperwork, is noted in the following flowchart.

Expense Report Process Flow
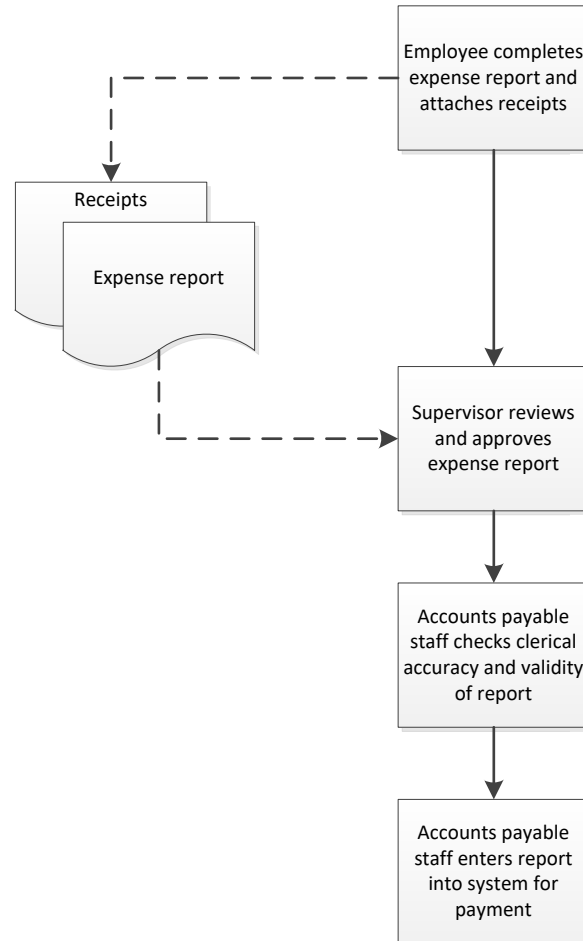
In-Process Accounts Payable Controls

In this section, we cover the controls that can be imposed on the core expense report processes. In addition, refer to the Additional Expense Report Controls sections for other controls that are positioned outside of the core expense report transactions.

1. Expense Report Submission

The proper submission of expense reports can be accomplished through several possible controls. They are:

- *Use a standard report format*. The accounts payable staff cannot reasonably be expected to sort through a pile of receipts to determine how much to pay an employee. Consequently, employees should be forced to use a reporting form to organize their submissions.
- *Issue reporting guidelines*. Employees may rightfully take the position that they are being denied reimbursement because of a company rule of which they had no knowledge. Accordingly, issue a brief document to the staff, detailing expense submission guidelines.

> **Tip:** Employees will not read the reporting guidelines if they are too long – as is the case when you simply extract them from the employee manual. Instead, consider compressing them down into a block that will fit on the expense reporting form.

- *Require approval for all expense reports.* The intent of this control is to notify supervisors of the expenses that are about to be charged against their departments. The control can be mitigated to skip approval for very small expense reports.

> **Tip:** In the Accounts Payable Controls chapter, we noted that supplier invoices can be entered in the system either before or after approval. The same issue applies here. If expense reports are being manually inputted to the system by the payables staff, it generally makes more sense for expense reports to be approved in advance. If employees are entering the information into an automated system, the system will request approval after data entry.

- *Adopt an invoice numbering method.* If the accounts payable staff is entering expense reports into the accounting system, the software will not accept the entry unless there is an invoice number. Consequently, there needs to be an invoice numbering procedure in place to reliably derive invoice numbers.

> **Tip:** The invoice numbers derived for expense reports are usually based on the date of an expense report (such as setting an invoice number of 080715 for an expense report dated August 7, 2015). However, employees frequently copy forward their Excel templates from the last expense report and then forget to change the date, resulting in a warning from the software that a duplicate invoice is being entered, even when an expense report is clearly unique. One way to avoid this problem is to base the invoice number on the date of the first or last entry in an expense report, which is nearly certain to generate a unique invoice number. It is generally not useful to base the invoice number on the approval date, since an employee may submit multiple expense reports to a supervisor at the same time for approval.

2. Expense Report Examination

The examination of expense reports can range from a cursory review to a startling amount of in-depth analysis. The most basic controls are noted here, with a number of additional controls listed later in the Additional Expense Report Controls sections. The basic controls are:

- *Compare expenditures to company policy.* Claimed expenditures should fall within the parameters set by the company's travel and entertainment reimbursement policy. The payables staff likely has this policy memorized, and so can review expense reports in search of any non-reimbursement items.
- *Verify receipts.* There should be a receipt for every item listed on an expense report. Ideally, a credit card statement can be used in place of some receipts, while handwritten receipts can be used to document cash payments.
- *Examine non-receipt expenditures.* In many expense report systems, employees are exempted from supplying receipts for items below a certain dollar limit, perhaps in the belief that doing so would be cruel and unusual punishment. Employees may take advantage of this rule by claiming a number of reimbursement requests that are just under the exemption level. Consider tracking the total dollar amount of these claims by employee, to see if anyone is taking an unusual number of them.

> **Associated Policy:** A great way to eliminate the problem of small-dollar expenditures with no receipts is to disallow them by requiring receipts for all expenses. The policy could be: *Every expense submitted for reimbursement must be accompanied by a receipt.*

Alternative Expense Report Control Systems

In this section, we assemble a selection of the controls just described and apply them to different expense report scenarios involving manual and automated expense reporting. While there are certain similarities in the controls used for each system, there are also crucial differences to consider when constructing your own system of controls.

Control System for Manual Expense Reporting

A manual expense reporting system requires a complete set of controls, since there is no automated review process to take some of the work load away from the accounts payable staff. This means that a standard reporting form and associated guidelines should be issued, and that an invoice numbering scheme be deployed to mitigate the risk of having the system reject a unique expense report as having already been entered. A complete suite of examination controls should also be considered.

These controls are noted in the following control chart, where controls are clustered under the basic expense reporting tasks.

Control System for Manual Expense Reporting

1. Expense report submission

> Use a standard report format

> Issue reporting guidelines

> Require approval for all expense reports

> Adopt an invoice numbering method

2. Expense report examination

> Compare expenditures to company policy

> Verify receipts

> Examine non-receipt expenditures
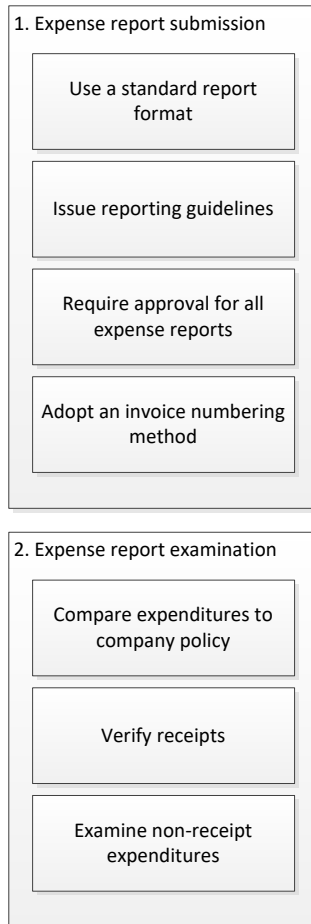
Control System for Computerized Expense Reporting

A computerized expense reporting system where employees enter their own information into an online form requires substantially fewer controls during the submission phase. First, there is no need for a standard printed form, since the online entry form takes its place. Second, it can be argued that reporting guidelines are no longer needed, since they are incorporated into the rules used to examine submissions in the automated system. Third, there is no need for an invoice numbering method, since there are no longer any invoice numbers. The examination phase still requires the same controls enumerated for a manual system, but they are usually handled automatically by the system; comparing expenditures to company policy is relatively easy to automate, while the remaining two controls (regarding receipt verification and non-receipt expenditures) may still call for human intervention.

These controls are noted in the following control chart, where controls are clustered under the basic expense reporting tasks.

Control System for Computerized Expense Reporting

```
┌──────────────────────────────────────┐
│ 1. Expense report submission         │
│   ┌──────────────────────────────┐   │
│   │   Require approval for all   │   │
│   │       expense reports        │   │
│   └──────────────────────────────┘   │
└──────────────────────────────────────┘

┌──────────────────────────────────────┐
│ 2. Expense report examination        │
│   ┌──────────────────────────────┐   │
│   │   Compare expenditures to    │   │
│   │       company policy         │   │
│   └──────────────────────────────┘   │
│   ┌──────────────────────────────┐   │
│   │       Verify receipts        │   │
│   └──────────────────────────────┘   │
│   ┌──────────────────────────────┐   │
│   │    Examine non-receipt       │   │
│   │      expenditures            │   │
│   └──────────────────────────────┘   │
└──────────────────────────────────────┘
```
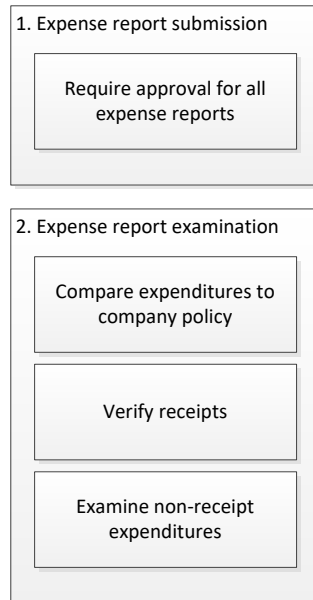
Additional Expense Report Controls – Fraud Related

There is a very good chance that fraud will occur in the expense reporting area, since it delivers cash directly into the hands of employees. Accordingly, consider implementing the following controls to prevent or at least detect fraud:

- *Restrict access to the vendor master file*. Many accounting systems require that employees be set up in the vendor master file in order to pay them. If so, make sure that a password is required to restrict access to the file; this is particularly important if the file contains the employee bank account information needed for direct deposit payments.
- *Review employee expense trends*. There may be an unusual blip in the expenses charged by an employee in a particular month that was not caught by any of the in-process controls. Once investigated, the system can be modified to catch similar offending transactions in the future.

> **Tip:** Formulate a trailing 12-month expense report for each employee, detailing the expense accounts charged in each month from their expense reports. This is the best source of information for conducting an expense trend analysis.

- *Review for multiple flight bookings*. An employee could book several flights for the same trip, submit the highest-priced flight on his or her expense report, and obtain refunds for the remaining flights. To guard against this, trace airline travel to the credit card statement.
- *Review detailed hotel billings*. Employees can pile a number of additional expenditures onto their room charges, such as meals and in-room movies and games, so have employees submit the detailed hotel bills for examination.
- *Review for excessive miles*. Given the high mileage reimbursement rate, someone might take advantage of the situation by reporting an excessive number of miles. When there

seems to be a clear overage, use an Internet search engine to estimate the miles that should have been driven, and point out the issue to the employee.

> **Tip:** If the company has common travel destinations, such as from the company headquarters to specific customers or suppliers, create a table that lists the miles that will be reimbursed for these standard trips, and issue it to employees.

- *Review actual receipts*. Many expense reporting systems allow employees to submit scanned copies of their expense receipts. If so, consider adding a requirement that they retain the original receipts for a few months following the expense report date, so that you can request to see the originals. This may reveal that some of the receipts were doctored to show larger expense amounts.

> **Tip:** What if you request to see the original receipt and the employee does not have it? Do not automatically assume that someone is hiding nefarious deeds – it is quite likely that they simply threw it away. However, make a note of the incident, and if repeated requests result in the same answer, it may be time to engage in a more detailed examination of that person's submissions.

- *Look for sequential receipt numbers*. An employee may have purchased a block of blank receipts from an office supply store and is using them to create fake receipts for fraudulent claims. If so, the receipts may be consecutively numbered, so look for the numbering across several consecutive expense reports. This control is a manual one, since no expense report systems track receipt numbers.

> **Tip:** A possible solution to the use of questionable receipts by employees would appear to be that all purchases must be made with a credit card, and that the credit card statement be submitted along with the expense report. Unfortunately, this does not work well for tips or other cash payments. One possibility is to require a credit card statement for nearly all expense submissions, with receipts allowed for only a small subset of expenses.

Additional Expense Report Controls – Periodic Actions

The following controls are useful for updating records related to expense reports. They are not necessarily part of a specific process; instead, the payables staff schedules them as separate tasks. These controls are:

- *Set employee vendor records to inactive after departure*. Many accounting systems require that employees be set up as suppliers in the vendor master file in order to process their expense report reimbursements. If so, periodically set these records to inactive status for any employees who have left the company. This prevents the accounting system from making additional payments to them.
- *Set employee status in automated system to inactive after departure*. If a company uses an online form and automated back end to process expense reports, it should set employees to inactive status in this system once they have left the company. Doing so prevents the system from letting them submit additional expenses for reimbursement.
- *Issue a new expense reporting form and guidelines once a year*. Update the standard reporting template once a year with the new mileage reimbursement rate, as well as any other information (such as reporting guidelines) that the company wishes to change on the form.

Additional Accounting Policies

There are several supplemental accounting policies that were not mentioned earlier in association with specific controls. These policies are:

- *All airline travel shall be booked and paid for by the company*. By having the company pay for airline travel, there is no way for an employee to commit fraud in relation to airline travel. This has the side benefit of possibly giving the company a volume discount on travel.
- *Hotel bills shall be submitted with expense reports*. Employees may have added extra charges to their hotel accounts, so require them to submit the hotel bills for perusal.
- *Commuting mileage will not be reimbursed*. This policy is fairly obvious, but is needed for those rare cases where an employee persists in attempting to be reimbursed for commuting.
- *All cash payments must be justified with a receipt*. This policy is intended to close one of the worst loopholes in the expense report system, which is reimbursing people for cash payments that may never have happened.
- *Employees will be reimbursed within __ days of expense report submission*. The number of days until payment should be quite short, since employees may need the cash to pay their credit card statements. This policy is designed to force the payables staff to make rapid payments.

In addition, there should be a policy related to meals. Management needs to make a decision about reimbursing the entire amount of meals or reimbursing on a per diem basis. Either approach works, though the sales staff is more likely to take clients out for meals, and so will not be able to work within the restrictions of a per diem system. The advantages and disadvantages of the two approaches are:

- *Per diem*. This reduces the paperwork included in an expense report. Also, it tends to force employees to purchase less expensive meals. There may be some gaming of the system, where employees purchase very inexpensive meals that cost less than the per diem, and pocket the difference.
- *Reimbursement*. There is more paperwork included in expense reports, but this is essentially a required method when taking business partners out for meals. A few employees will take advantage of this approach to buy inordinately expensive meals.

Summary

A great deal of this chapter has been concerned with the detection of fraudulent employee submissions on their expense reports. This does not mean that the payables staff should spend an inordinate amount of time reviewing every expense report under a microscope; doing so is not cost-effective. Instead, conduct a detailed review of a selection of expense reports. You will probably find that the vast majority of employees are totally honest, and may even underreport their submissions. However, you will occasionally find an employee who stretches or violates the rules. Once found, this person's expense reports should *always* be examined, as well as all of his or her prior submissions. Thus, the rule for expense report examinations is to audit them, with 100% reviews for any violators found.

Chapter 10 – Review Questions

The review questions accompanying this course are designed to assist you in achieving the course learning objectives. The review section is not graded; do not submit it in place of your qualified assessment. While completing the review questions, it may be helpful to study any unfamiliar terms in the glossary in addition to course content. After completing the review questions, proceed to the review question answers and rationales.

19.   A valid control for a cash payment by an employee is:

     a. Avoided with a policy of not requiring any receipts
     b. To explicitly deny reimbursement for cash payments
     c. To pay it with a check
     d. To have them submit a receipt

20.   A computerized expense reporting system:

     a. Can dispense with a standard printed expense reporting form
     b. Requires the use of an invoice numbering procedure
     c. Requires the use of a detailed reporting guideline manual
     d. Is used for purchase requisitions

Chapter 11 – Procurement Card Controls

Learning Objectives
After completing this section of the course, you will be able to:
- Identify the controls needed to provide a secure environment for the use of procurement cards.

Introduction
Procurements cards are used to purchase lower-cost items, thereby avoiding the more complex and expensive process of issuing purchase orders. By consolidating the paperwork for purchases into a small number of procurement card statements, the work load of the accounts payable department can be greatly reduced. Though these advantages are considerable, there are new risks associated with procurement cards that are not present in the normal purchasing and accounting processes – hence the need for this chapter.

We first address the main tasks involved in the handling of procurement cards, then describe process-specific controls, and then show the control systems most likely to be needed for the following situations:
- Procurement cards with no transaction logs
- Procurement cards with transaction logs

We conclude with a discussion of a number of additional procurement card controls and related policies.

> **Related Podcast Episode:** Episode 4 of the Accounting Best Practices Podcast discusses procurement card controls. It is available at: **accountingtools.com/podcasts** or **iTunes**

Procurement Card Process Overview
From a controls perspective, the use of procurement cards involves three primary activities, each of which requires differing levels of control, depending on the volume of card activity. The activities are:
1. Purchasing
2. Reconcile card statements
3. Approve card reconciliations

A narrative description of these three activities follows.

1. Purchasing
Procurement cards are assigned to those people most likely to make small-dollar purchases on behalf of their departments. These cards may contain a variety of restrictions, of which the most common are a daily maximum charge and a monthly maximum charge. Users of the cards are pre-authorized to make purchases for their departments, with the expectation that all purchases made will be charged to that department.

2. Reconcile Card Statements
At the end of each month, the bank servicing the procurement cards submits statements to the company showing the amounts charged to the cards. The company passes these statements through to the card holders, who are responsible for reviewing the statements and assigning account codes to each item charged. There are varying levels of review that can be conducted here. The card holders then send these statements, along with any reconciliation documents, to their supervisors for review and approval.

3. Approve Card Reconciliations
The supervisor who reviews and approves a procurement card reconciliation should be the department manager, since the expenses coded on the statement will be charged to his or her department. This person pays particular attention to whether any expenses can be charged to a different department, or perhaps to an asset account, such as prepaid expenses; these changes reduce the expenses immediately charged to the department.

Once approved, the supervisor forwards the card statement and reconciliation to the accounts payable staff for data entry and subsequent payment. The payment process is described in the Accounts Payable Controls chapter.

The general flow of these three procurement card steps, including the associated paperwork, is noted in the following flowchart.

Procurement Card Process Flow

```
                          ┌──────────────────┐
                          │  Employees use   │
                          │ procurement cards│
                          │ to make purchases│
                          └──────────────────┘
                                   │
                                   ▼
┌──────────────────┐      ┌──────────────────┐
│    Monthly       │      │  Company sends   │
│ procurement card │─────▶│  procurement card│
│   statements     │      │ statements to card│
│                  │      │     users        │
└──────────────────┘      └──────────────────┘
                                   │
                                   ▼
                          ┌──────────────────┐
                          │ Employees review │
                          │ statements and add│
                          │ account codes to be│
                          │     charged      │
                          └──────────────────┘
                                   │
                                   ▼
                          ┌──────────────────┐
                          │ Supervisors review│
                          │   and approve    │
                          │    reconciled    │
                          │   statements     │
                          └──────────────────┘
                                   │
                                   ▼
                          ┌──────────────────┐
                          │ Supervisors send │
                          │  statements to   │
                          │accounts payable for│
                          │     payment      │
                          └──────────────────┘
```
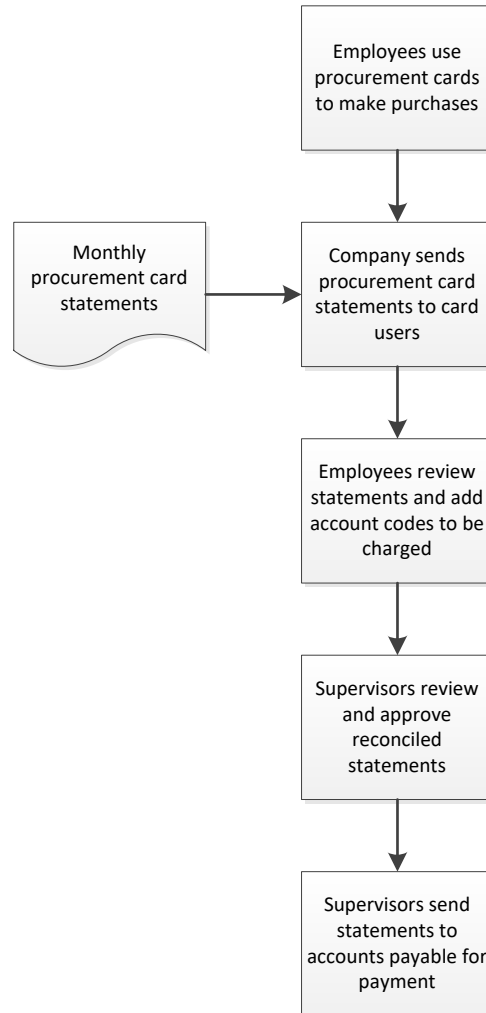
In-Process Procurement Card Controls

In this section, we cover the controls that can be imposed on the core procurement card processes. In addition, refer to the Additional Procurement Card Controls sections for other controls that are positioned outside of the basic procurement card transactions.

1. Purchasing

There are few controls at the purchasing stage, since the bulk of the controls are detective, and so appear later in the process. The main control is to have any number of restrictions built into the procurement cards, so that employees are limited from making incorrect or excessively large purchases.

> **Related Policy:** The company may want to build purchasing restrictions into the purchasing rules embedded in a card, thereby limiting the risk of having someone make a really large purchase. Sample policies are: *Individual procurement card transactions shall be limited to $___,* or, *Daily procurement card purchases shall be limited to $___.*

Tip: Have the procurement card provider send a warning email to the procurement card administrator whenever a purchasing rule is breached, so the administrator can investigate the situation before more purchases are made.

2. Reconcile Card Statements

Once the bank has sent month-end statements to the company for each procurement card, the card users should at least examine the statements, assign account codes to each line item, and see if any expenditures appear to be incorrect. At a more advanced level, they can maintain their own transaction log and compare it to the summary shown on the statement; this latter approach is much more time-consuming, but is also the best way to spot potential problems with a statement. The following controls may apply to one or both of these approaches:

- *Issue a standard account code list.* Given the large number of items typically purchased with procurement cards each month, it is common to find a substantial amount of coding to incorrect accounts. This problem can be mitigated by issuing a standard account code list to card users, possibly alongside each monthly statement.
- *Maintain a transaction log.* It is possible for infrequent card users to simply scan through their month-end card statements, assign account numbers to each line item, and be comfortable in signing off on them. However, a heavy card user who may make dozens or even hundreds of purchases per month should take a more detailed view of the situation, and so tracks each purchase in a log and then reconciles this log to the card statement.
- *Reconcile transaction log to card statement.* The person responsible for each procurement card should match his or her transaction log to the month-end card statement. The reason for this review is not only to verify that all charges are correct, but also to use the usage notations in the transaction log to code the expenditures on the card statement into the most appropriate accounts. Examples of problems that a card user may find include charges altered by the supplier, duplicate charges, and unexplained credits.
- *Complete missing receipts form.* There will inevitably be cases where card users lose receipts. When this happens, they should fill out a one-page missing receipt form that describes the nature of each expenditure on the card statement for which there is no receipt. This is later used for a formal review and approval of missing receipts.
- *Complete expenditure protest form.* Card users should fill out a one-page form that details all the line items on the card statement that they are protesting, and the reasons for their recommendations not to pay. This information is used to remove items from the card statements.
- *Retain a copy.* Some procurement card holders are extremely heavy card users, and so may generate a large amount of transaction volume. These holders might consider retaining their own copies of procurement card reconciliation packages for future reference purposes. Doing so can be of assistance from a control perspective, since the copies make it easier for them to research possible card-related issues.

Once all of the preceding controls have been completed, each card user assembles the card statement, transaction log, all receipts, the missing receipts form, and the protest form into a reconciliation package, and forwards it to the department manager for approval. Or, if the "no log" control version is used, only an adjusted card statement may be forwarded, along with receipts.

3. Approve Card Reconciliations

The department manager should review each procurement card reconciliation package in detail, since the expenditures involved can be substantial. This may require a discussion with the card user, as well as consideration of whether any expenses can be shifted to another department or into an asset account.

Then, the manager approves the packages and forwards them to the accounts payable department for data entry and payment.

Alternative Procurement Card Control Systems

In this section, we assemble a selection of the controls just described and apply them to different procurement card scenarios involving either no transaction log or the use of a transaction log. A transaction log provides a useful cross-check against any errors that might appear in the card statement, but is time-consuming to maintain. Thus, neither approach is necessarily better than the other.

Procurement Card Control System without a Transaction Log

The lack of a transaction log reduces the core group of procurement card controls to a very small number. There will likely be built-in preventive controls to keep excessive purchases from being made, while card users are required to review the card statements, and supervisors must approve them. These controls are noted in the following control chart, where controls are clustered under the basic procurement card processing tasks.

Control System for No Transaction Log

1. Purchasing

> Include purchasing restrictions in card rules

2. Reconcile card statements

> Issue a standard account code list

> Review card statement

3. Approve card reconciliations

> Approve card statement
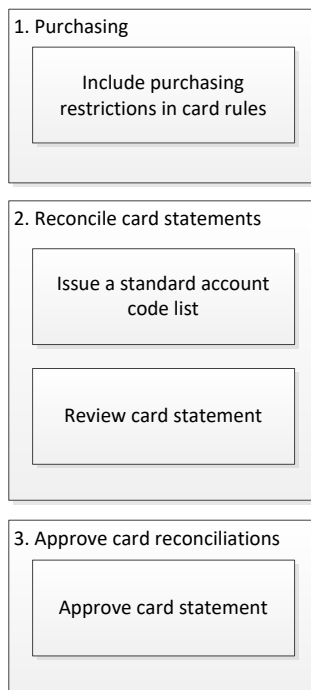
Procurement Card Control System with a Transaction Log

When a transaction log is required, the set of associated controls becomes much more extensive. The card user compares it to the card statement, notes any exceptions, and notes any items for which there are no receipts. The department manager then reviews and approves the packet of information, and forwards it to the accounts payable department. These controls are noted in the following control chart, where controls are clustered under the basic procurement card processing tasks.

Control System for a Transaction Log

1. Purchasing

> Include purchasing restrictions in card rules

2. Reconcile card statements

> Issue a standard account code list

> Maintain a transaction log

> Reconcile transaction log to card statement

> Complete missing receipts form

> Complete expenditure protest form

3. Approve card reconciliations

> Approve card statement
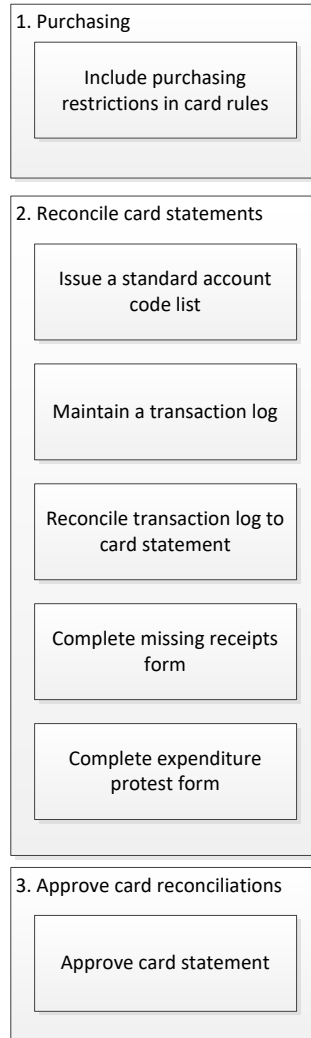
Additional Procurement Card Controls – Fraud Related

There is a reasonable chance that fraud will occur in the procurement card area, since it can be quite tempting to use a card to make a purchase unrelated to company business. Accordingly, consider implementing the following controls to prevent or at least detect fraud:

- *Separation of duties*. One person should order procurement cards from the bank, while a different person receives them from the bank and distributes them to employees. This

separation of duties keeps someone from ordering a card for a fake employee and then using it for personal reasons.

- *Conduct employee background checks*. It would be foolish to issue procurement cards to all employees, since some are more capable of handling them than others. One way to determine their capability is to conduct a background check on anyone who is targeted to receive a card.

> **Tip:** Many companies conduct background checks on employees when they are hired, so this information may already be available from the human resources department. Also, it may be prudent to gradually roll out the procurement card program, to see how the initial group fares with the added responsibility.

- *Cross-reference procurement card receipts to expense reports*. An employee could retain the receipts associated with procurement card purchases and use them to claim reimbursement on his or her expense report. This can be found by cross-checking the expenses on the procurement card statement and the expense report.
- *Review expense trends*. There may be an unusual blip in an expense line item in a particular month that was not caught by any of the in-process controls. Once investigated, the system can be modified to catch similar offending transactions in the future.

> **Tip:** Formulate a trailing 12-month report that shows the monthly results for each of the preceding 12 months for every expense account, by procurement card. This is the best source of information for conducting an expense trend analysis.

While this control may be useful for spotting larger anomalies, they are not of much use if there are discerning perpetrators on the premises. Knowing that these controls exist, someone could hide a series of improper payments by incurring relatively small charges over a long period of time.

- *Terminate lost cards at once*. The company should mitigate its liability by having a system in place to terminate lost procurement cards as soon as possible. The easiest method is to plaster the contact information for the procurement card administrator on every document sent to card users, so that they know who to call.
- *Retrieve procurement cards as part of terminations*. The human resources staff should have an item on its employee termination checklist to retrieve any procurement cards held by terminated employees, to prevent them from making purchases after they have left.
- *Cancel the procurement cards of terminated employees*. The person responsible for procurement cards should cancel the card of any person who leaves the company, even if they have turned in their cards. The problem is that the terminated employees may still have access to the card numbers, and so can still pay for items without the physical cards (for example, using Internet stores).

> **Test:** The person responsible for the procurement card program may not be aware of employee departures, especially if there are many employees. Accordingly, the human resources staff should have an item on their terminated employee checklist to notify the procurement card manager of all departures.

Additional Procurement Card Controls – Periodic Actions

The following controls are useful for keeping costs down or making operations more efficient. They are not necessarily part of a specific process; instead, these are separate tasks. The controls are:

- *Require users to sign a contract*. The company should prepare a procurement card usage agreement that states the responsibilities of the user, and what happens if cards are misused. This agreement not only makes responsibilities very clear to the user, but may also be of assistance in obtaining repayment from card users if they buy unauthorized goods or services.
- *Issue an approved supplier list*. The company may have a spend management program under which it directs its purchasing activity at certain suppliers in order to obtain volume discounts. A good control over this program is to issue a list of approved suppliers to procurement card users.

> **Tip:** If procurement card volumes are sufficiently high to improve the company's volume discounts with suppliers, it may be cost-effective to review the Level III data (see next) to ensure that only approved suppliers are being used. Purchases from unapproved suppliers can then be discussed with the card users.

- *Review Level III data*. Procurement card providers can send a company more information than is available for a typical consumer credit card. This additional information is known as Level III data, and includes the items purchased, item descriptions, quantities purchased, prices paid, sales taxes, freight charges, and purchase order numbers. This information may be useful for delving into exactly what is being purchased.

> **Tip:** If you elect to receive Level III data, obtain it as a download, so that the information can be re-sorted on a spreadsheet. Also, it may not be cost-effective to review this level of detail for all procurement cards; instead, consider only using it when you suspect that there have been questionable purchases.

- *Investigate bill of materials purchases*. If the company has a computerized manufacturing planning system, that system should automatically notify suppliers of purchasing requirements, usually as releases under a blanket purchase order. Thus, any items listed on a bill of materials (the official list of the components of a product) should never appear in the Level III data for a procurement card.

> **Tip:** If someone buys a bill of materials item with a procurement card, this is strong evidence that the manufacturing procurement process has broken down, since someone probably had to buy parts on a rush basis, and outside of the normal purchasing process. This requires investigation to locate the cause of the problem and correct it. Sample causes are incorrect inventory records, incorrect bills of material, and unusually high scrap levels.

Additional Accounting Policies

There are several supplemental accounting policies that were not mentioned earlier in association with specific controls. These policies are:

- *Cash advances shall be prohibited for procurement cards.* This policy is a rather obvious restriction on the cards, so that they cannot be used to withdraw cash from an ATM. There should be no valid business reason for a cash withdrawal.

- *Only the procurement card manager is authorized to alter card spending limits.* This policy mandates that the bank be notified that only one person is allowed to change card spending limits, thereby reducing the risk of someone altering their own card limits and overspending.

> **Tip:** It may also be useful to report card spending limits to the controller once every month or quarter, for additional oversight. This report should be based on actual spending limit information provided by the bank, not by the procurement card administrator's recollection of the limits.

Summary

Procurement cards require no prior purchase order authorization, and there may not be any evidence of receipt at the receiving dock, so several of the primary controls used for more typical accounts payable cannot be applied to it. Instead, the controls involve a few preventive ones (mostly spending limits) and a larger number of detective ones. Thus, it is entirely possible that there will be an ongoing flow of smaller expenditures that would not have been made under a traditional accounts payable system. If these expenditures become large in aggregate, it may make sense to shift some purchases away from procurement cards and back to the traditional purchase order system.

Chapter 11 – Review Questions

The review questions accompanying this course are designed to assist you in achieving the course learning objectives. The review section is not graded; do not submit it in place of your qualified assessment. While completing the review questions, it may be helpful to study any unfamiliar terms in the glossary in addition to course content. After completing the review questions, proceed to the review question answers and rationales.

21.   Procurement cards are assigned:

    a. To those employees most likely to make smaller purchases on behalf of their departments
    b. With minimal restrictions
    c. Under the assumption that all users can make charges on behalf of all departments
    d. To all employees

22.   A transaction log is intended:

    a. To monitor the timing of receipt of purchased items
    b. For the use of infrequent card users
    c. For the use of frequent card users
    d. To replace the credit card statement if it does not arrive

Chapter 12 – Petty Cash Controls

Learning Objectives
After completing this section of the course, you will be able to:
- Specify the steps in the petty cash process flow, how petty cash can be replaced, and the controls that can be instituted for petty cash.

Introduction
Petty cash is a form of accounts payable processing, for it is a method of paying for very small expenditures with cash. The amounts involved are minor, so some companies have minimal control systems for petty cash, on the grounds that the largest possible amount of loss is quite small. While this is a reasonable assertion over the short-term, the absence of controls makes petty cash a near-certain source of fraud.

In this chapter, we describe the control systems needed to maintain a moderate degree of control over petty cash. We first address the three main activities involved in petty cash, then describe process-specific controls, and then show the control system needed for the day-to-day handling of petty cash. We conclude with a discussion of several additional petty cash controls and related policies.

> **Related Podcast Episode:** Episode 169 of the Accounting Best Practices Podcast discusses petty cash controls. It is available at: **accountingtools.com/podcasts** or **iTunes**

Petty Cash Process Overview
Petty cash processing involves three primary activities, each of which may require controls. The activities are:
1. Fund petty cash
2. Disburse petty cash
3. Document petty cash expenditures

These activities are unusual in that only the second step (disbursing cash) occurs on a regular basis. The funding and documentation of petty cash are far less frequent, but are still necessary parts of the petty cash process. A narrative description of these activities follows.

1. Fund Petty Cash
A petty cash fund is typically set up for each department where there is a history of smaller, short-term cash requirements. This means there could be quite a few petty cash funds within a single facility. Alternatively, a smaller business may operate a single petty cash fund for the entire organization. These funds are initially set up with a modest amount of cash that is intended to fund all reasonable cash requests for a short period of time, such as a few weeks to a month. This cash is stored in a drawer or cash box. When the cash level in the petty cash box declines to a certain point, it is refreshed with more cash.

When cash is added to a petty cash box, the transactions that had been used to draw down the cash balance are first documented and recorded in the general ledger as expenses. Cash is then added to the box to bring its cash balance up to the designated level.

2. Disburse Petty Cash

The person who authorizes the payment of cash from the petty cash box is the petty cash custodian. This is a part-time job taken on by an administrative person within the department where the box is located. The company generally has a set of guidelines for which types of expenses the custodian is allowed to reimburse. When someone wants to be paid in petty cash, they must exchange the cash taken out of the box with some type of documentation that is evidence of the expenditure. Thus, the total of the cash and documentation in the box should always equal the amount of funding designated for the box.

3. Document Petty Cash Expenditures

The amount of cash paid out for various expenditures must be periodically recognized in the financial statements. The amount of expense is so small that this is not necessarily a requirement when the books are closed. Instead, it is more commonly documented whenever it is time to reload the petty cash box with more cash.

Documentation of petty cash expenditures involves adding up all of the receipts in the box, assigning them account numbers, and creating a journal entry to record them. This is usually done with a standard petty cash journal entry form, since there are typically only a small number of expense accounts applicable to petty cash.

The general flow of these petty cash steps, including the associated paperwork, is noted in the following flowchart.

Petty Cash Process Flow
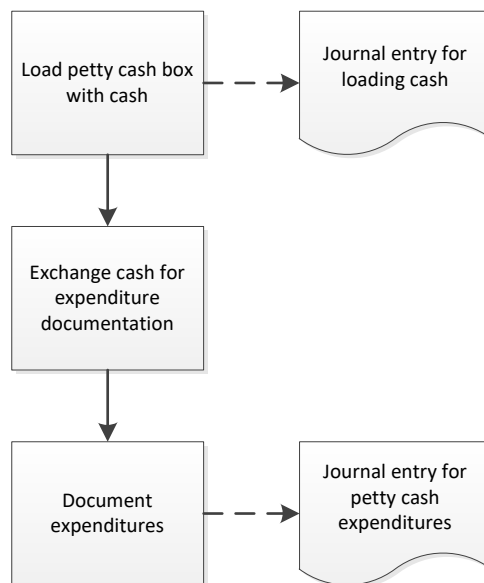
In-Process Petty Cash Controls

In this section, we cover the controls that can be imposed on the core petty cash process. In addition, refer to the Additional Petty Cash Controls section for other controls that are positioned outside of the basic petty cash transactions.

1. Fund Petty Cash

It is of moderate importance to keep some cash in the various petty cash boxes; otherwise, employees may badger the accounting staff to cut manual checks for small expenditures. The following control addresses this situation:

- *Require a monthly petty cash funding review*. There should not be so much cash in the petty cash box that it represents a serious temptation for someone to steal it. Instead, schedule a monthly review to see if more cash is needed, and set the petty cash amount to a level that should have the remaining cash balance running low by about the time of the review.

> **Associated Policy:** It is difficult to create a policy that specifies a certain petty cash funding level, since petty cash activity levels vary over time. Instead, consider using a funding policy that sets the funding level at the most recent usage level. For example: *The authorized petty cash level shall be the average amount of petty cash usage during the past three months.*

2. Disburse Petty Cash

The core of the petty cash process is the disbursement of cash. The following controls are needed to ensure that there is sufficient documentation of each disbursement:

- *Require receipts for all cash withdrawals*. When employees request funds from petty cash, they should always submit a receipt in exchange. This receipt may be a receipt from a supplier whom the employee has just paid out of his own pocket, or it may be a form filled out by the employee, stating the purpose of the payout. The amount on the receipt should always match the exact amount paid out, so that the sum of the cash and the receipts in the petty cash box at any time always equal the designated funding level for the box.
- *Employees sign for cash received*. Whenever an employee takes petty cash, he or she must sign a "Received of Petty Cash" form (available at any office supply store), which states the amount paid out. The petty cash custodian then staples the receipt submitted by the employee to the Received of Petty Cash form. This information packet remains within the petty cash box, providing evidence that cash was paid out for a certain purpose and that a specific person received the cash. It is later extracted and attached to a journal entry documenting the use of cash.
- *Fill out receipts in ink*. An employee could submit a receipt or Received of Petty Cash form in exchange for cash from the petty cash box, after which the petty cash custodian could increase the amount on the receipt or form and remove the related amount of extra cash. To make it more difficult to alter receipts and forms in this way, require employees to complete them in ink, not pencil.

3. Document Petty Cash Expenditures

It is extremely common for the petty cash custodian to make mistakes in properly documenting payments from the petty cash box. The following controls are designed to locate these problems, as well as to aggregate expenditures into the proper accounts in the general ledger:

- *Use a standard expense form*. Though there are usually many petty cash expenditures, they tend to fall into a small number of expenditure categories, such as office supplies. To ensure that petty cash is always consistently charged to the same accounts, construct a form for recording petty cash expenditures that incorporates a standard set of the most common accounts used.

- *Reconcile petty cash*. An essential step in petty cash processing is to periodically reconcile the account. This involves adding up the amount of cash and receipts in the petty cash box, matching it to the designated petty cash balance, and researching any differences. Petty cash is an area in which errors are common, so a periodic reconciliation is needed to keep the petty cash records close to reality.

The Petty Cash Control System

In this section, we assemble a selection of the controls just described and apply them to the petty cash system. There are no variations on the petty cash concept (as opposed to the many system variations listed in other chapters), so we present only the single control chart shown below. The funding review noted in the chart is not entirely necessary, since the petty cash custodian will probably notify the accounting department when petty cash levels are getting low. Of the other controls in the chart, the most important is requiring receipts for all cash withdrawals; otherwise, there is no evidence to support disbursements, nor is there a basis for documenting the accounts to be charged.

Control System for Petty Cash

1. Fund petty cash

> Require monthly funding review

2. Disburse petty cash

> Require receipts for cash withdrawals

> Employees sign for cash received

> Fill out receipts in ink

3. Document expenditures

> Use a standard expense form

> Reconcile petty cash
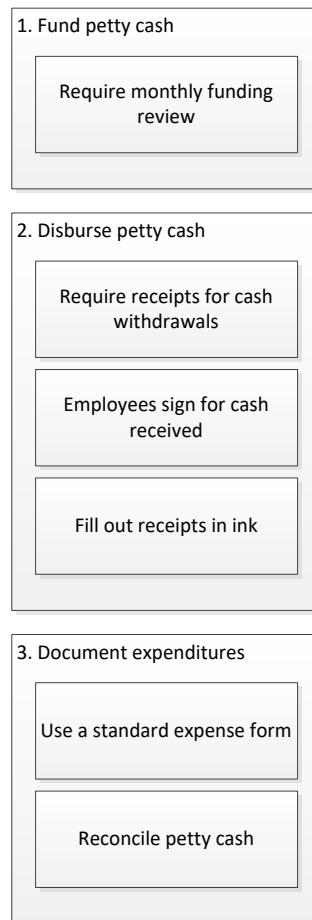
Additional Petty Cash Controls – Fraud Related

There is an excellent chance that fraud will occur in the petty cash area, since it involves the disbursement of cash. Accordingly, consider implementing the following controls to prevent or at least detect fraud:

- *Eliminate petty cash*. The best control over petty cash is to not have petty cash. This completely eliminates the risk of loss. A reasonable replacement for a petty cash system is a combination of company procurement cards (see the Procurement Card Controls chapter) and requiring employees to pay for items themselves and then request reimbursement from the company by check or direct deposit. If there is a continuing need for petty cash, then at least consider reducing the number of petty cash boxes in use.

- *Conduct random audits*. It is fairly common for the petty cash custodian to use petty cash as a personal bank, pulling out funds for personal use from time to time. You can spot this issue and others by conducting a series of random audits. Even if no issues are ever found, the mere presence of these reviews will encourage the custodian to keep a tightly-run petty cash box.

- *Track reimbursements by person on a trend line*. It is entirely possible that a few employees will figure out that they can falsify receipts and obtain a small amount of cash by making submissions to the petty cash custodian at relatively long intervals. If reimbursements are tracked by person over time, it may be possible to detect these submissions. However, the cost of detecting the problem may not be worth the savings generated by putting a stop to it.

- *Bolt down the petty cash box*. One of the easier ways to steal from the petty cash box is to steal the entire box. This risk can be eliminated by bolting down the box. A variation on the concept is to install a contact alarm under the petty cash box that is triggered as soon as the box is lifted out of direct contact with the alarm device.

- *Require receipts to spell out sums issued*. If employees are required to fill out receipts with fully spelled-out amounts, it is less likely that someone can later alter the amounts. Thus, a $30.00 receipt would be submitted as "Thirty Dollars."

Additional Accounting Policies

There are several supplemental accounting policies that were not mentioned earlier in association with specific controls. These policies are:

- *The petty cash box shall be locked in the absence of the petty cash custodian*. The policy is essentially stating that the petty cash box is to be locked unless it is in use. It contains cash, so it would otherwise be too easy for someone to enter the area, reach into the box, and extract cash.

- *Petty cash cannot be used to pay for invoices of more than $__*. There is a chance that supplier invoices can be paid twice – once through petty cash, and again as a direct submission to the accounts payable system. This policy should reduce the number of invoice payments being run through the petty cash box, thereby reducing the risk of duplicate payments. A variation on this policy follows next.

- *Individual petty cash reimbursements shall not exceed $__*. This policy is designed to restrict petty cash usage to very small incidental items. All other payments must therefore be routed through the accounts payable system.

- *Employee advances and traffic citations cannot be reimbursed from petty cash*. Certain types of payments, such as employee advances and traffic citations, require approval

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from someone higher in the company than the petty cash custodian, so this policy prevents the custodian from making such payments. The policy can be expanded to encompass other types of expenditures, such as payments for gifts.

Summary

Petty cash is a relatively small part of a company's system of handling expenditures, but it requires a surprisingly large number of controls. This is because it involves the relatively insecure storage of loose cash within a business. Though the theft or misuse of petty cash in a single event may not result in a large loss for a business, its long-term pilfering can add up to quite a significant amount. Consequently, given the large number of controls and prospects for long-term losses, it may be worthwhile not to operate a petty cash system at all.

Chapter 12 – Review Questions

The review questions accompanying this course are designed to assist you in achieving the course learning objectives. The review section is not graded; do not submit it in place of your qualified assessment. While completing the review questions, it may be helpful to study any unfamiliar terms in the glossary in addition to course content. After completing the review questions, proceed to the review question answers and rationales.

23.　　The amount of cash stored in a petty cash box:

    a.　Is replenished every business day
    b.　Should be reconciled every day
    c.　Is kept high so that fewer replenishments will be needed
    d.　Is kept low in order to be a less tempting target

24.　　A petty cash reconciliation:

    a.　Is not needed
    b.　Should be completed once a year
    c.　Is not needed if there is only one petty cash box
    d.　Is used to keep the petty cash records close to reality

Chapter 13 – Receiving Controls

Learning Objectives
After completing this section of the course, you will be able to:
- State the controls used in the receiving area, as well as the proper treatment of customer-owned goods.

Introduction
Receiving involves the efficient processing of incoming goods in terms of their authorization and identification, as well as notifying the rest of the company that they are now in-house. In this chapter, we describe the control systems used to monitor all aspects of receiving. We first address the two main types of receiving, then describe process-specific controls, and then show the control systems most likely to be needed for the following situations:
- Receiving with a manual system
- Receiving with a computerized system

We conclude with a discussion of a number of additional receiving controls and related policies.

Related Podcast Episode: Episode 7 of the Accounting Best Practices Podcast discusses receiving controls. It is available at: **accountingtools.com/podcasts** or **iTunes**

Receiving Process Overview
There are two entirely different types of receiving. Most of the time, goods are arriving from suppliers after they were ordered by the company's purchasing department. In a few cases, the company's own products are being returned to it by customers, after the returns were authorized by the order entry or customer service departments. Despite the differences in origination and authorization, both types of deliveries are handled by the receiving department. Separate narrative descriptions of these two activities follow:

1. Receive Ordered Goods
When a delivery arrives, the receiving staff examines it to see if it was authorized, and if the product type and quantity is as specified by the company's purchasing department. If the delivery is acceptable, the receiving staff fills out a receiving report and sends a copy to the accounts payable clerk (see the Accounts Payable Controls chapter). The receiving staff staples a copy of the packing slip to its own copy of the receiving report for filing within the department, and forwards the delivery to the warehouse, where it is logged into the inventory tracking system and stored.

If the company has a computerized procurement system, the receiving staff can enter the purchase order associated with a delivery into the computer system, along with the quantity received. The system automatically makes this information available to the accounts payable clerk, so there is no need to forward any documents to that person. The system automatically generates a receiving report, if anyone finds it necessary to print out this information. The system may also log the received items into inventory, though no warehouse location code can be assigned until it is moved into the warehouse.

2. Receive Returned Goods
When deliveries arrive that are for returned products, the receiving staff logs them into a returns database and forwards them to the warehouse staff for evaluation. These goods may no longer be in sellable condition, or may require repackaging or other refurbishing, and so should be tracked separately from normal inventory items. The receiving staff completes a return merchandise authorization (RMA) notification form and forwards a copy to the billing clerk, who uses it to issue a credit to the customer.

The general flow of these receiving activities, including the associated paperwork, is noted in the following flowchart.

Receiving Process Flow
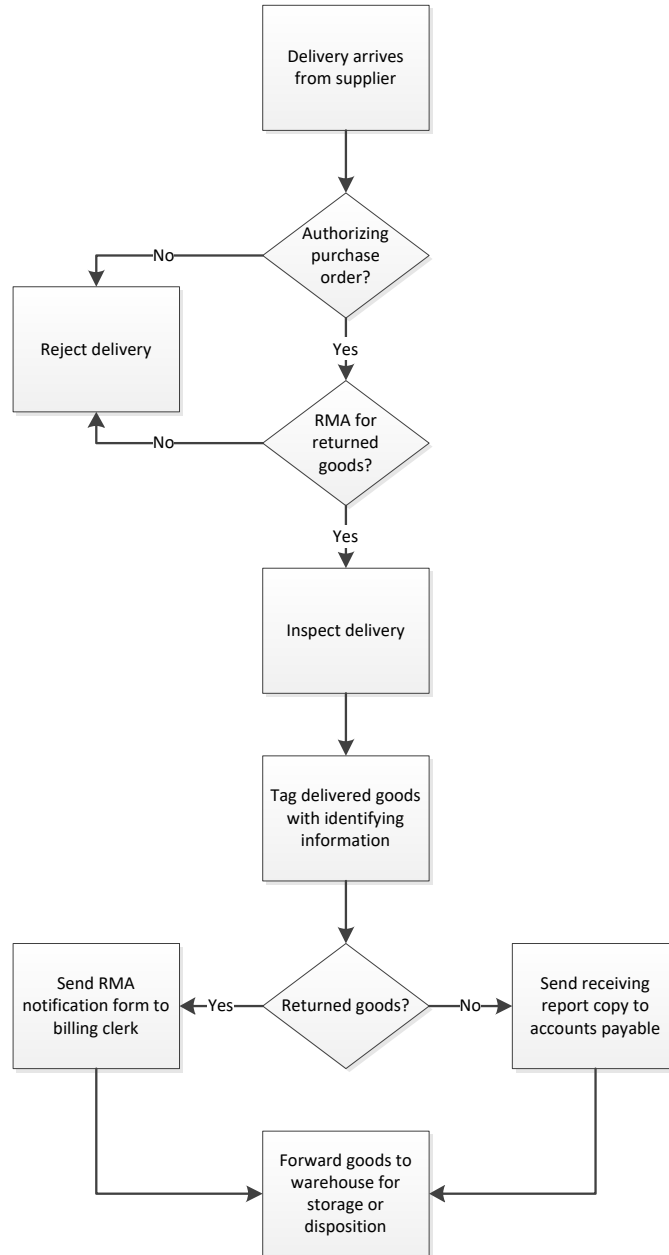
In-Process Receiving Controls

In this section, we cover the controls that can be imposed on the two types of receiving processes. In addition, refer to the Additional Receiving Controls sections for other controls that are positioned outside of the basic receiving transactions.

1. Receive Ordered Goods

The controls related to the receipt of ordered goods begin with testing them for various issues, and then recording them in a format that can be used by the rest of the company. The controls are:

- *Only accept deliveries for which there is a purchase order*. If a company has a policy of issuing purchase orders for all major purchases, the receiving staff should reject deliveries that are not authorized with a purchase order. This forces employees to work through the purchasing department to order goods.

> **Tip:** This is a very difficult control to enforce, since other valid purchases may have been made with procurement cards, and so have no purchase order assigned to them. One way to avoid a debacle is to automatically accept deliveries from certified suppliers, on the grounds that they would not ship without a valid order. Also, if an item is clearly related to the cost of goods sold, the receiving department may be authorized to accept it irrespective of a missing purchase order, since it may be a rush order that is needed right now. Another option is to assign the same purchase order number to all items bought with procurement cards, just so that they will be accepted at the receiving dock.

> **Associated Policy:** It can be very difficult to train employees to obtain a purchase order for larger purchases, so consider implementing the following policy: *All purchases exceeding $___ must be authorized in advance with a purchase order*.

- *Fully inspect all deliveries*. The general rule is to inspect all deliveries for quantity delivered, the product numbers delivered, and any damage.

> **Tip:** A more efficient approach is to certify those suppliers who have clearly superior shipping accuracy, so that their deliveries are automatically accepted. This greatly improves the efficiency of the receiving staff.

- *Test count received items*. On a random basis, the receiving manager can open up all packaging and conduct a complete count of a delivery. This may occasionally find quantity or quality problems for which the purchasing department should be notified for further action.

> **Tip:** Test counts can be more heavily targeted toward those suppliers with whom the company has had delivery problems in the past.

- *Reject excess material*. Suppliers sometimes run up their invoice amounts by shipping somewhat more than was authorized by the company. It is particularly important for the receiving staff to locate and reject these items when the company does not need any additional units, as is the case for short production runs.

> **Tip:** It is not necessary to reject excess material when the company uses it on a continuing basis, as long as the overages are not excessive.

- *Flag customer-owned goods*. There are situations where a customer may send in goods that the company will modify and then send back. The receiving staff must flag these items as customer-owned, so that they are not mistakenly included in the company's ending inventory calculations.

> **Tip:** There are usually so few customer-owned items in stock that employees tend to assume that they are company-owned. The receiving staff can make this less likely by taping a brightly-colored label to these items as soon as they are received.

- *Tag all received inventory.* There should be a standard form on which the receiving staff notes the part number, description, unit of measure, and unit quantity for all received items. This makes it more efficient for the warehouse staff to identify and record items entering the warehouse.

> **Tip:** The company can require its suppliers to provide this information on a company-mandated form, preferably one that already contains the same information in a bar coded format. This simplifies the work of the receiving staff, and may allow it to scan received items directly into the inventory database.

- *Complete receiving reports.* A formal receiving report is needed to document the arrival of goods for the accounts payable staff. This control is not needed in a computerized system, where the receiving staff simply checks off received items in an online purchase order.
- *Maintain a receiving log.* It may be sufficient to record receipts on receiving reports for forwarding to the accounts payable staff, but a more organized approach is to also summarize them in a receiving log. The accounting staff can use this information to determine which received items arrived after the end of an accounting period, and so should be recorded in the next accounting period.

2. Receive Returned Goods

When goods are being returned to the company by its customers, the controls are similar to the testing used for received goods, except that the examination is based on a return merchandise authorization (RMA). The controls are:

- *Only accept returns for which there is a return merchandise authorization.* If the company sells in bulk to retailers and wholesalers, it is particularly likely that they will simply ship back all unsold goods if allowed to do so. To prevent this, the order entry staff issues RMA numbers when a customer provides a reasonable reason for a return. The receiving staff is required to reject all returns that do not have an accompanying RMA number. This can be a major control, depending on the possible volume of unauthorized returns that would otherwise be received.
- *Only accept items authorized on an RMA.* It is relatively common for retailers and wholesalers to obtain RMAs for a small number of items, and then ship back considerably more than the amount that was authorized. Thus, the receiving staff should compare each delivery to the RMA authorization.
- *Thoroughly log all returned items.* Items being returned to the company may not be in as organized a state as when they were originally shipped to customers. Thus, it is important to identify exactly what was returned in the receiving log.

Alternative Receiving Control Systems

In this section, we assemble a selection of the controls just described and apply them to different receiving scenarios that involve manual and computerized systems. While there are certain similarities in the controls used for each system, there are also differences to consider when constructing your own system of controls.

Control System for Receiving with a Manual System
The following list of recommended controls for a manual receiving system is somewhat shorter than the list described in the last section, since we are focusing on the more high-volume control applications. If purchase orders are used, the receiving staff should only accept orders authorized by a purchase order, after which they should inspect and tag all received items, and then record them.

The use of return merchandise authorizations is quite similar to the use of purchase orders, except that RMAs are used for items being returned by customers. The receiving staff should be careful to only accept items specifically noted in the RMA associated with a delivery, after which they need to log in the receipts for use by the warehouse and the customer billing clerk.

These controls are noted in the following control chart, where controls are clustered under the basic receiving tasks.

Control System for Receiving with a Manual System

1. Receive ordered goods

Only accept deliveries with purchase orders

Fully inspect deliveries

Tag received inventory

Complete receiving reports

Maintain receiving log

2. Receive returned goods

Only accept returns with valid RMA

Only accept items listed on the RMA

Log all returned items
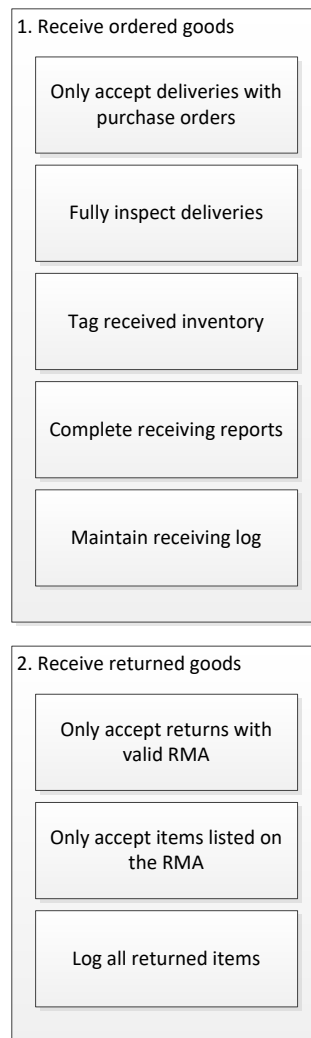
Controls for Receiving with a Computerized System

The controls for a computerized receiving system are quite similar to those for a manual one, except that the recordation of transactions occurs in the receiving database, rather than on any forms or logs. These controls are noted in the following control chart, where controls are clustered under the basic receiving tasks.

Controls for Receiving with a Computerized System

1. Receive ordered goods

> Only accept deliveries with purchase orders

> Fully inspect deliveries

> Tag received inventory

> Record receipt in computer system

2. Receive returned goods

> Only accept returns with valid RMA

> Only accept items listed on the RMA

> Record receipt in computer system
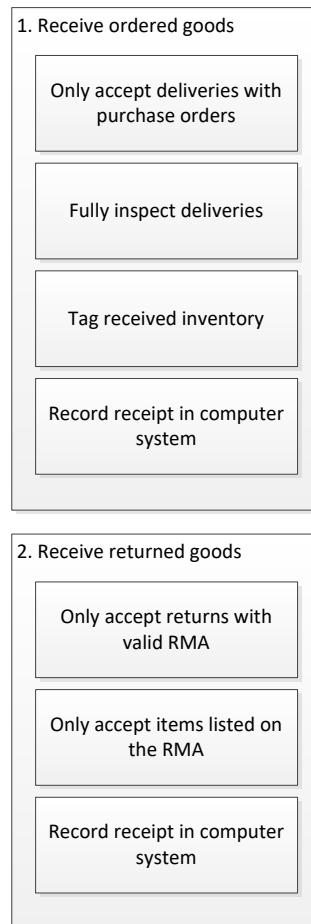
Additional Receiving Controls – Fraud Related

There is a chance that goods could be fraudulently recorded as having been received. The following controls are designed to prevent or detect this issue:

- *Password-protect receiving software.* If someone working with a supplier could access a company's receiving software and fraudulently log in a delivery as received, the company would pay for it even though it never arrived. To reduce this risk, use passwords to protect access to the receiving software.
- *Use a transaction log to record receiving transactions.* If someone accesses the receiving software to fraudulently log in a delivery as received, this can be detected with a transaction log that is attached to the receiving database. The log should record the identification of the person making the entry, as well as the nature of the entry.

- *Separation of duties*. The person who authorizes the purchase of goods should not also receive it. If this were allowed, someone could authorize a purchase, log it in as having been received (so that the company would pay for it), and then remove it from the premises.

Additional Receiving Controls – Periodic Actions

The following controls are useful for keeping track of receiving reports, as well as for improving the accuracy of inventory records. They are not necessarily part of a specific process; instead, the receiving staff schedules them as separate tasks. These controls are:

- *Prenumber and track receiving reports*. If a company has a manual receiving system, prenumber the receiving forms. By doing so, the receiving manager can keep track of the form numbers, and will know when forms are missing.
- *Review receiving reports*. The receiving manager or the internal audit staff should periodically review receiving reports to see if the receiving staff did an adequate job of inspected delivered goods.
- *Compare packing slips to inventory receipt transactions*. The warehouse staff typically counts received items again before recording them in the inventory database. The internal audit staff should periodically audit received goods to see if there are differences between the amounts stated on the packing slips that accompanied delivered goods and the quantities recorded by the warehouse staff.

> **Tip:** It is of particular interest when this control reveals that there are disparities between the packing slip quantities and recorded quantities for the same supplier on multiple occasions. This suggests that the supplier in question is persistently issuing incorrect packing slips, which in turn suggests that it is shipping smaller quantities than it should.

- *Segregate received items during a physical inventory count*. If a company is engaged in a physical inventory count, the receiving staff should segregate all items received after a cutoff point prior to the start of the counting process. Otherwise, received items could be inadvertently included in the physical count for which there are not yet any supplier invoices in the accounting system (which would reduce the reported cost of goods sold).

Additional Accounting Policies

There are several supplemental accounting policies that were not mentioned earlier in association with specific controls. These policies are:

- *The receiving staff shall use a standard review procedure for delivered goods*. This policy is intended to introduce some consistency to the process of reviewing received items, so that each delivery is inspected and documented in the same way.
- *Received goods shall be moved into warehouse storage as soon as possible*. Access to the receiving area tends to be more open than to the warehouse, so the risk of theft from the receiving area is higher than from the warehouse. This policy is designed to shift goods to the lower-risk warehouse area as soon as possible.

Summary

The receiving function has the goals of only accepting those items that a business needs, of ensuring that the items received are what they are supposed to be, and of informing the rest of

the organization that they are now in-house. The first goal, accepting only needed items, calls for the use of either purchase orders or RMAs to restrict deliveries. The second goal, ensuring that receipts are what they are supposed to be, calls for a substantial amount of verification work by the receiving staff. The third goal, informing the organization, calls for the timely and accurate recordation of every type of receipt, and circulating this information to those people who need it. Only the last goal varies to any extent between manual and computerized receiving systems, since computerization eliminates the need for forms and logs, and can more rapidly disseminate information. Otherwise, the control environment is similar for both types of systems.

Chapter 13 – Review Questions

The review questions accompanying this course are designed to assist you in achieving the course learning objectives. The review section is not graded; do not submit it in place of your qualified assessment. While completing the review questions, it may be helpful to study any unfamiliar terms in the glossary in addition to course content. After completing the review questions, proceed to the review question answers and rationales.

25.   Rejecting excess material at the receiving dock:

      a. Should be required even for small variances
      b. Is needed when there are longer production runs
      c. Is less necessary when the materials are being used on a continuing basis
      d. Is illegal

26.   Items to include on an inventory tag in the following, **EXCEPT** for:

      a. Price
      b. Unit of measure
      c. Description
      d. Part number

Chapter 14 – Payroll Controls

Learning Objectives
After completing this section of the course, you will be able to:
- Recognize the activities needed to create a proper payroll control environment, and the indicators of payroll fraud.

Introduction
Payroll requires the assembly and marshaling of a great deal of timekeeping information, which presents the risk of many errors when it is converted into the payroll database. It is also an area in which fraud can be rife. Both circumstances require the creation of a robust system of controls. In this chapter, we first address the five main tasks involved in payroll, then describe process-specific controls, and then show the control systems most likely to be needed for the following situations:
- Manual payroll systems
- Automated payroll systems
- Outsourced payroll systems
- Cash payroll payments

We conclude with a discussion of a number of additional payroll controls and related policies.

Related Podcast Episode: Episode 14 of the Accounting Best Practices Podcast discusses payroll controls. It is available at: **accountingtools.com/podcasts** or **iTunes**

For a complete discussion of payroll systems, please refer to the author's *Payroll Management* book.

Payroll Process Overview
Payroll processing involves five primary activities, each of which may require controls, depending on the circumstances. The activities are:
1. Collect time information
2. Data entry
3. Calculate gross and net pay
4. Payment
5. Remit taxes

A narrative description of these activities follows.

1. Collect Time Information
The first step in the payroll process is to collect information about the time worked by employees. This is always needed for hourly employees, and may also be collected for salaried employees under some circumstances. They can submit this information in many ways, including time cards, time sheets, online timekeeping systems, and smart phones. Written information must be manually aggregated by the payroll staff for data entry, while more automated collection methods may already be presented in a summarized format that interfaces directly into the payroll system.

2. Data Entry

The next step in payroll processing is to enter timekeeping information into a payroll system, which may be a manual record keeping system, a software package, or an outsourced application that is accessed through an Internet site. The information may be automatically ported into the system if it was collected by some automated means, or a payroll clerk may need to summarize and input it by hand.

In addition to data entry for time keeping information, the payroll staff may also need to enter information from adjustment forms that are used for deductions, pay rate changes, and so forth. Further, some companies provide employees with online forms that they can use to update a limited amount of payroll information, such as their bank account numbers and mailing addresses.

3. Calculate Gross and Net Pay

If a company uses outsourced processing or a software package, the calculation of gross pay and net pay is fully automated. However, a manual system requires the payroll staff to compile gross pay by hand, as well as to calculate all payroll taxes from tax tables, and incorporate other deductions. Depending on the calculation system used, this information is usually summarized on a payroll register, which is used for review purposes and (for manual payments) as a source document for creating payments.

4. Payment

If a company uses outsourced processing or a software package, it has the capability to easily pay employees with checks, direct deposit, and/or pay cards. If payroll is manually processed, all payment methods are still available, but direct deposit and pay card payments must be handled through third parties. Given the extra work involved, it is more likely that a manual processing operation will confine itself to check or cash payments.

5. Remit Taxes

If a company uses outsourced payroll processing, the supplier should be able to remit taxes to various government entities on behalf of the company. If a company processes payroll on an in-house software package or does so manually, it must make these remittances itself, which involves making payments by very specific due dates, and using government-supplied remittance forms.

Of the preceding steps, the ones most likely to cause issues (and therefore require controls) are timekeeping, payments, and tax remittances. Timekeeping calls for the marshaling of a large amount of information within a short period of time, which is difficult to achieve with perfect accuracy. Payments are much simpler to generate, but there is a risk of fraud. Tax remittances can result in significant penalties, since payments are very time-sensitive.

The general flow of these five payroll steps, including the associated paperwork, is noted in the following flowchart.

Payroll Process Flow

```
┌──────────────┐        ┌──────────────┐                    ▢
│              │        │ Collect      │                   ▢▢
│ Time sheets  │ ─ ─ ─ ▶│ employee     │◀ ─ ─ ─ ─ ─ ─ ─ ─ ─
│              │        │ hours worked │
└──────────────┘        └──────────────┘         Computerized time clock
                               │
                               ▼
                        ┌──────────────┐
                        │ Summarize    │
                        │ hours worked │
                        │ information  │
                        └──────────────┘
                               │
┌──────────────┐              ▼
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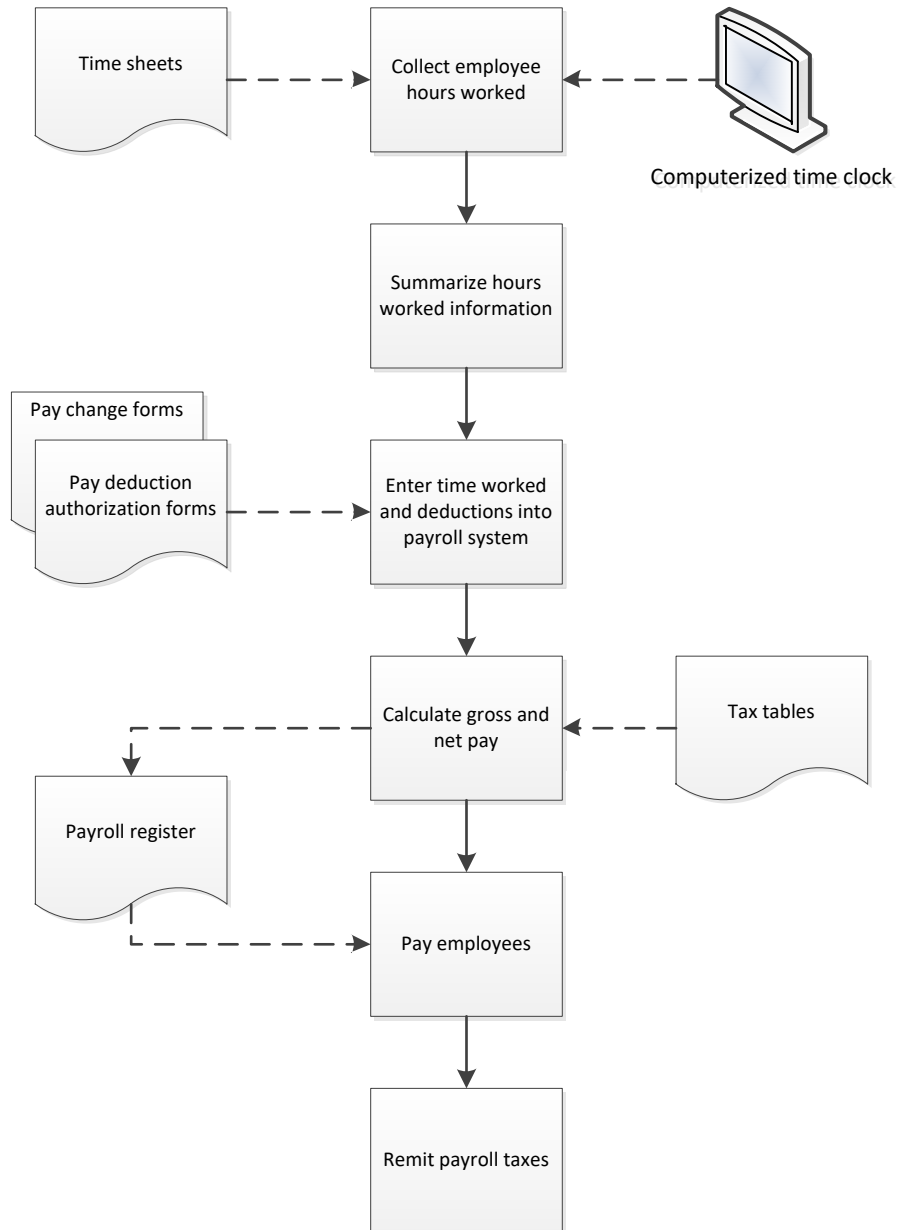
In-Process Payroll Controls

In this section, we cover the controls that can be imposed on the core payroll processes. In addition, refer to the Additional Payroll Controls sections for other controls that are positioned outside of the basic payroll process flow.

1. Collect Time Information

Controls are needed over time collection to ensure that all timesheets have been collected, and that the amounts reported are valid. These controls are:

- *Install automated timekeeping*. Install computerized time clocks. These clocks have a number of built-in controls, such as only allowing employees to clock in or out for their

designated shifts, not allowing overtime without a supervisory override, and (for biometric clocks) eliminating the risk of buddy punching. Buddy punching occurs when a third party clocks an employee in and out of a timekeeping system, even though the employee is not working. Also, send any exception reports generated by these clocks to supervisors for review.

> **Associated Policy:** It can be quite difficult to convince some employees to submit time reports. A reasonable policy for assisting in the collection of time keeping information is: *No employee shall be paid without the submission of a complete time sheet covering the entire pay period*.

- *Match timesheets to employee list*. There is a risk that an employee will not turn in a timesheet in a timely manner, and so will not be paid. To avoid this problem, print a list of active employees at the beginning of payroll processing, and check off the names on the list when you receive their timesheets.

> **Tip:** Make sure that the most recent employee list is obtained from the human resources department. In particular, you need to know which employees are new, because they may not know that they need to submit a timesheet.

- *Verify hours worked*. Have supervisors approve hours worked by their employees, to prevent the employees from charging more time than they actually worked.

> **Tip:** The payroll staff is usually operating under an extremely tight deadline for payroll processing, so make sure that all supervisors have designated alternates available to review timesheets, in case they are not available.

- *Verify overtime worked*. Even if supervisors are not required to approve the hours worked by employees, at least have supervisors approve overtime hours worked. There is a pay premium associated with these hours, so the cost to the company is higher, and is a temptation for employees to claim them.

> **Associated Policy:** Since overtime involves a much higher rate of pay, employees will be more tempted to record overtime on their timesheets, and the company will be less enthusiastic about paying it. A reasonable policy for controlling overtime is: *No overtime shall be paid without prior supervisory approval*.

> **Tip:** An additional control to consider is to track overtime hours by employee on a trend line. This may highlight those employees who persistently record very small amounts of overtime on a continuing basis, on the theory that a supervisor will approve these small amounts without much investigation.

- *Confirm self-service changes*. When employees enter their own updates to the payroll system, it should send them a confirming email, describing the changes made.

> **Tip:** The payroll staff can monitor the self-service system to see if any confirming email messages bounce, and then obtain replacement addresses.

2. Data Entry

It is quite easy to make mistakes when manually entering timekeeping information into a payroll system, and when setting up electronic payment information. You should also ensure that changes to employee deductions and pay rates have been authorized. The related controls are:

- *Verify aggregation calculations*. If payroll is being manually calculated, have a second person verify the aggregation of hours worked. A second person is more likely to conduct a careful examination than the person who originated the calculations.
- *Match entered totals to timesheets*. If there has been a history of errors in entering timekeeping information into the payroll software, consider adding a control to match the entered totals to the aggregated totals listed on employee timesheets. If automated timekeeping systems are in use, this information will be entered automatically, and no control is needed.
- *Require change authorizations*. Only allow a change to an employee's marital status, withholding allowances, or deductions if the employee has submitted a written and signed request for the company to do so. Otherwise, there is no proof that the employee wanted a change to be made. The same control applies for any pay rate changes requested by a manager.
- *Require pre-noting*. Pre-noting is used to conduct a trial test of a direct deposit transaction. Though this feature delays the start of direct deposits by one payroll, it is quite useful for spotting incorrect bank numbers and account codes. It is especially important when employees are allowed to alter their direct deposit information with a self-service system, since they are more likely than the payroll staff to input incorrect information. In particular, they may use information from their bank account deposit slips, rather than their checks; deposit slips do not necessarily contain the correct bank and account number information.

3. Calculate Gross and Net Pay

If payroll is being calculated manually, there is a risk that taxes will be incorrectly calculated, and that taxes and deductions may be incorrectly applied to gross pay. There are fewer concerns if payroll software is used, though the following payroll register controls should still be employed. The controls are:

- *Review calculations*. If payroll calculations are being conducted manually, have a second person verify the payroll calculations, tracing back to the summary totals to be paid to each employee, and checking taxes, deductions, and net pay calculations.
- *Review preliminary payroll register*. In a computerized system, the first evidence that the payroll clerk may have made a mistake will appear on the preliminary payroll register. A major control is to engage in as many iterations of this report as necessary, printing the register, looking for mistakes, correcting the mistakes, printing a replacement register, and so on.
- *Manager approves final payroll register*. Once all time information has been entered in the payroll system and wages and related deductions have been calculated, print a final payroll register that summarizes this information, and have a manager review and approve it.

> **Tip:** Auditors consider a reviewed and signed payroll register as evidence of a strong payroll control, so retain copies of the final, signed registers for all payrolls.

4. Payment
The bulk of the controls noted below pertain to payment by check, since that is still a predominant form of payment. Several controls near the bottom of the list are targeted at cash payments. Many payment controls are necessary for checks, because there are risks of fraud and errors in multiple places during their storage, printing, and distribution. The controls are:

- *Use a separate bank account*. Pay employees from a separate checking account, and fund it only in the amount of the checks paid out. Doing so prevents someone from fraudulently increasing the amount on an existing paycheck or creating an entirely new one, since the funds in the account will not be sufficient to pay for the altered check.
- *Split check printing and signing*. One person should prepare checks, and a different person should sign them. By doing so, there is a cross-check on the issuance of cash.
- *Store all checks in a locked location*. Unused check stock should *always* be stored in a locked location. Otherwise, checks can be stolen and fraudulently filled out and cashed. This means that any signature plates or stamps should also be stored in a locked location.

> **Tip:** If there is a signature stamp or plate, store it in a different locked location from the check stock, and keep the keys to the two locations in different spots. Ideally, different people should be responsible for the check stock and the signature plate. This makes it more difficult for someone to obtain both and generate valid-looking check payments.

- *Secure check-printing equipment.* Some printers are only used for check printing. If so, keep them in a locked location so that no one can print checks and have the integrated signature plate automatically sign the checks.
- *Track the sequence of check numbers used*. Maintain a log in which are listed the range of check numbers used during a check run. This is useful for determining if any checks in storage might be missing. This log should not be kept with the stored checks, since someone could steal the log at the same time they steal checks.
- *Issue checks in numerical order*. This is not actually a control, but rather a means of ensuring that there are few gaps in the sequence of check numbers that need to be investigated. From a practical perspective, checks are nearly always used in batches, so they will always be issued in numerical order.
- *Match check total to calculations*. If paychecks are being manually created, have a second person compare the amount on the checks to the net pay amounts indicated in the payroll register. The person who writes the checks is less likely to be thorough in matching these amounts.

> **Tip:** A common mistake is to cut a manual check for the gross pay amount, rather than the net pay amount listed on the payroll register. To keep this from happening, use a highlighter to mark the net pay amounts on the register prior to writing checks.

- *Sign checks*. In a smaller company where there are few employees, it may make sense to avoid a signature plate or stamp, in favor of manual check signing. Doing so increases the odds that the check signer may spot an issue. A further control here is to require two check signers for really large payments, just to introduce an additional reviewer.

> **Tip:** When there are multiple forms of payment, having someone sign checks may no longer be adequate. An alternative is to have someone periodically compare the amounts actually paid to the approved payroll register to ensure that they match.

- *Hand checks to employees*. Where possible, hand checks directly to employees. Doing so prevents a type of fraud where a payroll clerk creates a check for a ghost employee and pockets the check. A ghost employee is a fake employee record to which payments are fraudulently made. It could be an entirely fabricated person, or else a former employee whose record still indicates that he or she is an active employee. If this is too inefficient a control, consider distributing checks manually on an occasional basis.
- *Lock up undistributed checks*. If a company does not distribute checks at once, they should be stored in a locked location. Otherwise, there is a risk of theft, with the person stealing the checks modifying them sufficiently to cash them.

> **Associated Policy:** The easiest way to avoid all of the preceding controls for check payments is to not pay employees with checks. The following sample policy can be used to enforce electronic payments: *All employees shall be paid by direct deposit or payroll card*.

- *Use ink on pay envelope*. When there are cash payments to employees, use ink to note the pay amount on the outside of each pay envelope, which makes it more difficult for someone to alter the amount to be paid.
- *Match payroll register to pay envelope*. When there are cash payments to employees, have a second person match the amount of cash in each pay envelope to the amount specified on the payroll register. This makes it more difficult for a payroll clerk to collude with an employee to pay him or her more cash. The second person should then initial each verified envelope, seal it, and transport all verified envelopes to the employees for distribution.
- *Obtain a receipt*. When there are cash payments to employees, have them sign a receipt in exchange that states the amount paid and the date of payment. Doing so gives you proof of payment, in case an employee later complains of being shortchanged or not paid at all. To make this control even more effective, insist on having each employee count the money in his or her pay envelope, rather than just signing off on the receipt without looking.
- *Use positive pay*. Positive pay is a program under which a company sends a file containing its check payment information to its bank; if a check is presented for payment and it is not on the list of checks issued by the company, the bank rejects it. This can eliminate check fraud, though there is some question of whether it is more beneficial to the bank (which could be liable for accepting fraudulent checks) or the company.

> **Tip:** It is easy to forget to notify the bank of check payments, especially manual checks that are created outside of the normal check printing process. Therefore, have an iron-clad bank notification system in place before enacting positive pay. It may help to run positive pay on a test basis for a few months to see how many check notifications were not made, and what caused them.

5. Remit Taxes

A business is liable for remitting the correct amount of withheld, matching, and other payroll taxes to various government entities, so be sure to use the following control to avoid late payment penalties:

- *Verify tax remittances*. The penalties associated with a late or missing tax remittance are severe, so have someone independently verify the amount of tax to remit, verify that the funds were actually sent to the government, and that the company received a receipt in exchange.

> **Tip:** Outsourcing payroll processing eliminates the tax remittance problem, since the supplier is now responsible for it.

Alternative Payroll Control Systems

In this section, we assemble a selection of the controls just described and apply them to different payroll scenarios involving a manual system, a computerized system, outsourced payroll processing, and cash payments. While there are many similarities in the controls used for each system, there are also crucial differences to consider when constructing your own system of controls.

Control System for Manual Payroll

In a manual payroll system, we assume that there are no automated timekeeping systems in place. Instead, the payroll staff compares an employee list to timesheets to ensure that all timesheets are received, and then has supervisors review and approve the timesheets. The payroll staff then aggregates the timesheet information and uses authorized pay change forms to calculate gross pay, uses approved deduction forms to calculate net pay, and then a second person verifies all calculations. This information is transferred onto a payroll register, which is reviewed and approved by the payroll manager.

Since this is a manual system, we assume that electronic payments will not be made to employees. Instead, all payments are made by check, which calls for separating the check printing and signing functions. In addition, someone should match the total on the checks to the calculations in the payroll register. Checks should be signed by hand to provide a further level of oversight. Finally, someone should verify that all tax remittances were sent, and that they were sent in a timely manner and using the correct payment forms.

These controls are noted in the following control chart, where controls are clustered under the basic payroll processing tasks.

Control System for Manual Payroll

1. Collect time information

> Match timecards to employee list

> Verify hours worked

2. Data entry

> Require change authorizations

> Verify aggregations

3. Calculate gross and net pay

> Review pay calculations

> Review payroll register

4. Payment

> Split check printing and signing

> Match check total to calculations

> Sign checks

5. Remit taxes

> Verify tax remittances
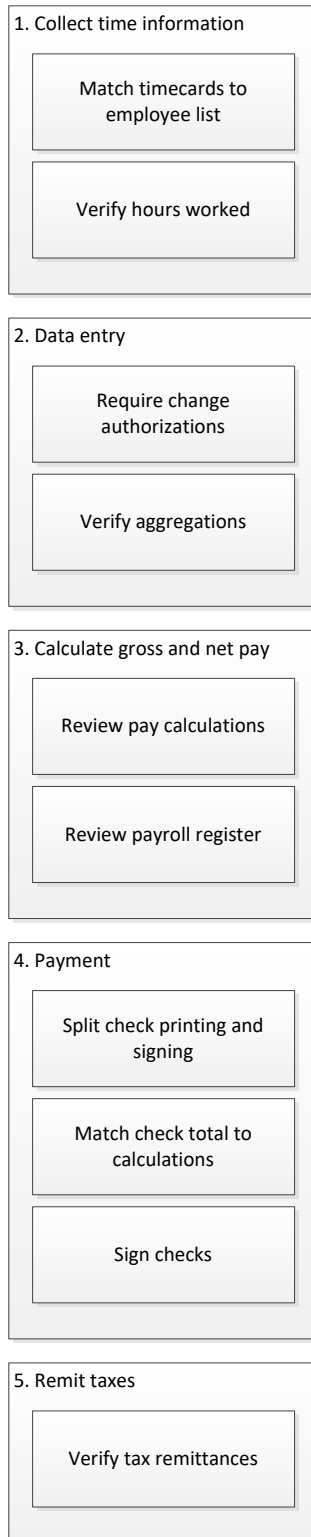
Control System for Computerized Payroll
The controls for a computerized payroll system vary in several key respects from the manual system just described. First, we assume there will be some kind of automated timekeeping system, which means that a computer system will report on missing time records or records that contain possible errors. Also, we assume there is a self-service module in which employees can make some changes to their employee records; this calls for a control that confirms any self-service changes they make.

There should be no bulk data entry in a computerized system for time records, since the timekeeping system should automatically load the information into the payroll system. However, there is still a need for authorizations for any types of deductions or pay changes. Further, if the company is paying by direct deposit, pre-noting should be required to ensure that bank number and account information is correct.

Calculations of gross and net pay are performed automatically by the payroll software, with the main verification point being the printing, review, and approval of a preliminary payroll register. It may require several iterations of the payroll register before a payroll is considered error-free, so the register is an excellent control for spotting problems.

There are a variety of ways in which employees may be paid from a computerized system, so check signing may not be necessary on the grounds that there are few checks to sign. Still, a reasonable control is to split the processing of payments and their final approval. This may be less a case of having a different person sign checks, and more a case of having someone periodically trace payments back to the approved payroll register to ensure that the correct payments were made. And, as was the case in a manual system, someone should verify that all tax remittances were sent, and that they were sent in a timely manner and using the correct payment forms.

These controls are noted in the following control chart, where controls are clustered under the basic payroll processing tasks.

Control System for Computerized Payroll

1. Collect time information

> Install automated timekeeping

> Verify hours worked

> Confirm self-service changes

2. Data entry

> Require change authorizations

> Verify pre-noting

3. Calculate gross and net pay

> Review preliminary payroll register

> Manager approves payroll register

4. Payment

> Split check printing and signing

5. Remit taxes

> Verify tax remittances
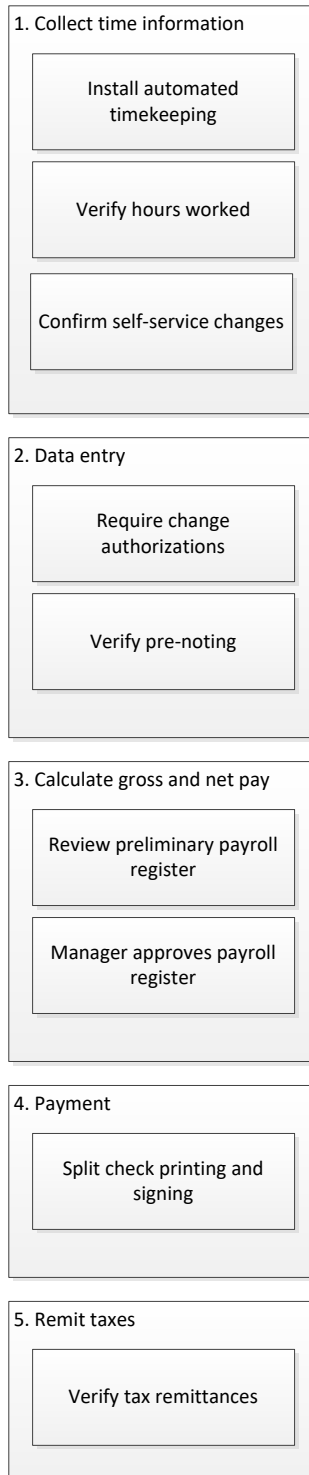
Control System for Outsourced Payroll
When a business outsources its payroll to a supplier, it is still responsible for collecting and entering timekeeping and other pay rate and deduction information into the supplier's system. Since a company can use either manual or automated systems for this front-end work, there may be a need for different sets of controls. In the following control chart, we have noted the controls for both manual and automated timekeeping systems. Once this information is fed into the supplier's payroll processing system, the payroll staff will use the payroll register to detect errors. Following approval of the final payroll register by a manager, the supplier is responsible for making payments to employees, as well as for remitting payroll taxes to the government.

> **Tip:** A key point is to ensure that the supplier's system has accepted and processed the most recent payroll file, so be sure to obtain and print a completed payroll notification message from the supplier.

Since the supplier's systems are taking the place of the company's systems in these final two steps, there is no need for controls in those areas. Thus, the following control chart shows an abbreviated set of controls that end following the calculation of gross and net pay.

Control System for Outsourced Payroll

Manual System | Computerized System

1. Collect time information
- Match timecards to employee list
- Verify hours worked

1. Collect time information
- Install automated timekeeping
- Verify hours worked
- Confirm self-service changes

2. Data entry
- Require change authorizations
- Verify aggregations

2. Data entry
- Require change authorizations
- Verify pre-noting

3. Calculate gross and net pay
- Review preliminary payroll register
- Manager approves payroll register

Control System for Cash Payroll Payments

There are comparatively few situations where employees are still paid in cash; it is mostly for day laborers where there is an informal time tracking system in place. Nonetheless, in the unlikely event that employees are being paid in cash from an automated timekeeping system, we include in the following control chart the controls for both manual and computerized systems that result in cash payments. The chart assumes that payroll software is used to calculate the amount to be paid; if that is not the case, use the controls already shown for manual payroll calculations.

The key change for cash payments is in the payment block, where a second party should compare the amount of cash in each pay envelope to the payroll register, to ensure that the correct amounts are being paid. Also, each recipient should be required to count the amount paid and then sign a receipt for the cash, thereby avoiding the risk of being accused of short-paying employees.

Control System for Cash Payroll Payments

Manual System   Computerized System

1. Collect time information

- Match timecards to employee list
- Verify hours worked

1. Collect time information

- Install automated timekeeping
- Verify hours worked
- Confirm self-service changes

2. Data entry

- Require change authorizations
- Verify aggregations

2. Data entry

- Require change authorizations

3. Calculate gross and net pay

- Review preliminary payroll register
- Manager approves payroll register

4. Payment

- Match payroll register to pay envelope
- Obtain a receipt

5. Remit taxes

- Verify tax remittances

Additional Payroll Controls – Trend Analysis

Some controls are not directly related to any of the process flows noted earlier. Instead, they are more of the investigative variety, and so are used to spot possible control problems after the fact. These controls include:

- *Compare to budget*. If a company has a tightly-controlled budgeting process, it may make sense to compare actual payroll expenses to budgeted amounts on a month-by-month basis and see if there are any variances that cannot be explained. These may indicate fraudulent activity, or they could simply be data entry errors where expenses were recorded in the wrong departments. In the latter case, there should be an offsetting favorable payroll variance in one department that offsets the unfavorable variance in another department.
- *Review expense trends*. There may be an unusual blip in an expense line item in a particular month that was not caught by any of the in-process controls. Once investigated, the system can be modified to catch similar offending transactions in the future.

> **Tip:** Formulate a trailing 12-month income statement that shows the monthly results for each of the preceding 12 months for every payroll-related expense account. This is the best source of information for conducting an expense trend analysis.

Additional Payroll Controls – Fraud Related

This section contains a vast number of controls that can be used to either prevent or at least detect fraud. It would be burdensome to install all of the controls noted here, but it may be useful to install those few that appear most applicable to the particular circumstances of a business. At least a few of these controls should certainly be installed, since payroll is a tempting area for someone intent on committing fraud, and preventing it can potentially save a great deal of money. The controls are:

- *Lock up all payroll documents*. Payroll files contain a large amount of sensitive information, including pay rates and social security numbers. These files should be stored in locked filing cabinets. It may be necessary to store the cabinets in a locked room.
- *Shred old payroll documents*. Never throw out or recycle old payroll records without first shredding them thoroughly. Otherwise, sensitive social security number and pay rate information may be left exposed for general viewing.
- *Only pay employees after an employee number has been assigned*. Give the human resources department sole control over the assignment of employee numbers to new employees, and make it impossible to pay an employee without an employee number. As long as the human resources staff only assigns employee numbers after conducting background checks and conducting drug tests, it should be much more difficult for someone to create a ghost employee.
- *Only allow direct deposit for employees with company email addresses*. This control makes it much more difficult for someone to create a ghost employee and send money to it, since they must also obtain authorization from either the human resources or information technology departments to create an email account.
- *Match security badge file to employee file*. The security staff should only issue security badges to employees who are physically present, so comparing the badge file to the employee file in the payroll system is a good way to spot ghost employees.

> **Tip:** Matching to a security badge file only has limited applicability, since many businesses have outlying facilities that do not require security badges, and that is where ghost employees are most likely to be set up.

- *Obtain a direct deposit authorization signature*. Have employees sign a form, stating their authorization for the company to pay them by direct deposit, to which is stapled a copy of a cancelled check for the designated account. This makes it more difficult for someone to fraudulently alter the bank account information.
- *Lock up direct deposit information*. Since direct deposit authorization forms include an employee's bank account information, lock them in a secure location, probably with the employee personnel folders.
- *Change passwords*. There is a risk that someone could obtain a password that permits access to the payroll software, and use it to alter payment amounts. To reduce this risk, mandate a relatively frequent password change, such as on a quarterly basis.
- *Restrict access to online records*. Use password protection if employee payroll records are stored on line. This precaution is not just to keep someone from accessing the records of another employee, but also to prevent unauthorized changes to records (such as a pay rate).
- *Monitor change tracking log*. If payroll is being processed in-house with a computerized payroll module, activate the change tracking log and make sure that access to it is only available through a password-protected interface. This log will track all changes made to the payroll system, which is useful for tracking down erroneous or fraudulent entries. The log should also track the user identification number under which changes were made.
- *Review payments without deductions*. If a payment has no tax deductions or other types of withholdings, there is an enhanced risk that this is a payment issued to a ghost employee, since these items would reduce the amount paid. Thus, you should run a report that searches for these payments and investigate them.
- *Approve negative deductions*. When an employee receives a negative deduction through the payroll system, it means that he or she is receiving additional cash. While a negative deduction can be used to correct an excessively large deduction in a prior period, it can also be used to fraudulently increase wages. Consequently, either require supervisory approval for negative deductions or at least run a report that highlights these items.
- *Look for double endorsements*. If someone is cutting checks to ghost employees, a good way to spot it is to look at the back of each deposited check to see if there are two endorsements. The first endorsement will be a forgery in the name of the ghost employee, while the second endorsement is the name of the employee cashing the check.
- *Match addresses*. If the company mails checks to its employees, match the addresses on the checks to employee addresses. If more than one check is going to the same address, it may be because a payroll clerk is routing illicit payments for ghost employees to his or her address.
- *Identify simultaneous deposits to the same account*. If an employee has created multiple ghost employees and pays them by direct deposit, it is likely that the payments will all be sent to the same bank account. Create a custom report that searches for this evidence of fraud.

> **Tip:** This control is less useful where married couples work for the same company, since it will continually flag payments into their common bank account as a control breach. The same issue applies to the preceding control for matching addresses.

- *Require pay change authorizations*. Consider requiring not just one approval signature for an employee pay change, but two – one by the employee's supervisor, and another by the next-higher level of supervisor. Doing so reduces the risk of collusion in altering pay rates.
- *Mark voided checks*. When a check is voided, do so not only in the accounting software, but also on the check itself, so that no one can cash it. This involves writing "Void" across the face of the check and cutting away or tearing the signature line.
- *Limit remittance advice information*. The remittance advice is the informational tear-away portion of a pay check. Employees routinely throw away their remittance advices without shredding them, so limit the information recorded on them. In particular, replace the social security number with the company-assigned employee number.
- *Conduct a background check for the payroll staff*. There should be a thorough background check for everyone involved in payroll processing, since someone with a history of fraudulent activities could wreak havoc in the department.
- *Separation of duties*. Have one person prepare the payroll, another authorize it, and another create payments, thereby reducing the risk of fraud unless multiple people collude in doing so. In smaller companies where there are not enough personnel for a proper separation of duties, at least insist on having someone review and authorize the payroll before payments are sent to employees.

Additional Payroll Controls – Periodic Actions

The following controls are mostly designed to locate payroll processing and data entry errors, but may also uncover instances of fraud. They are:

- *Audit the books*. Have the internal auditors conduct a periodic audit of the payroll function to verify whether payroll payments are being calculated correctly, employees being paid are still working for the company, time records are being accumulated properly, pay rates match supporting documents, and so forth.

> **Tip:** Schedule these audits at irregular intervals, and keep changing the focus of each review. Otherwise, someone committing fraud will know when to cover their tracks, and in which areas.

- *Examine deductions when benefits change*. When the cost of benefits change, employees are frequently asked to bear part of the burden. This calls for a general overhaul of deductions, during which it is very likely that some adjustments will be missed or made incorrectly. A review of all deductions by a second person is a good way to locate these errors.
- *Run error-checking reports*. Some types of errors can be spotted by running reports that only show items falling outside of the normal distribution of payroll results. These may not all indicate certain errors, but the probability of underlying errors is higher for the reported items. The payroll manager or a third party not involved in payroll activities should run and review these reports. Examples of error-checking reports are:

- o *Activity for terminated employees*. Shows payments being made to an employee who has left the company or is on leave; may indicate a case of fraud, or that the status of the employee should be changed to active.
  - o *Negative deductions*. Shows employees being paid through a negative deduction; usually indicates either a data entry error or fraud.
  - o *Negative accrued vacation*. Shows employees being paid for vacation time they have not accrued.
  - o *Net pay exceeds boundary*. Flags any net pay that exceeds a pre-determined trigger point; may indicate a data entry error or fraud.
  - o *No payments*. Shows active employees who received no pay; may indicate missing timesheets.
  - o *Pay rate exceeds boundary*. Flags any pay rate that exceeds a pre-determined trigger point; may indicate a data entry error or fraud.

- *Issue payment report to supervisors*. Send a list of payments to employees to each department supervisor, with a request to review it for correct payment amounts and unfamiliar names. They may identify payments being made to employees who no longer work for the company.
- *Match payroll register to supporting documents*. The payroll register shows gross wages, deductions, and net pay, and so is a good summary document from which to trace back to supporting documents for verification purposes. This is not a good control for every payroll, since it is very time-consuming, but can be used occasionally as a deterrent to anyone intending to commit payroll fraud.
- *Reconcile the payroll checking account*. Conduct a monthly reconciliation of the payroll bank account to detect any unauthorized transactions and undocumented bank charges. The person who creates the reconciliation should not be the same person who prepares or signs the checks. Better yet, if there is online access to the bank's account information, consider conducting a daily reconciliation, which will more quickly spot problems and lead to faster corrective action.
- *Review uncashed checks*. An uncashed check may indicate a flaw in the payroll process that sent a check to an incorrect address or a non-existent employee. This is particularly worthy of investigation if there are multiple uncashed checks to the same person.
- *Maintain a garnishment tracking log*. Maintain a tracking log that itemizes which garnishments have been received, the amount to be deducted, and the start and termination dates of garnishments. The payroll manager should periodically compare this log to the payroll register to ensure that required garnishments are being acted upon.
- *Match garnishment deductions to payables*. Periodically compare the garnishment deductions from the payroll system to the checks issued through the accounts payable system to the garnishing entity, to ensure that deductions are being forwarded in the correct amounts and by the required dates.

> **Tip:** It is entirely possible that there will be a disconnect between garnishment deductions in the payroll system and garnishment remittances in the accounts payable system, since these two systems are not linked and are usually run by different people. Therefore, schedule an ongoing review of deductions and remittances to ensure that the two systems are in sync.

- *Update tax rates*. The company should receive notifications at the end of each calendar year to update various tax rates in its payroll system. To ensure that this occurs, make a note in the department calendar of activities to check for tax rate updates by the end of the year. If the company outsources its payroll, it should forward these notifications to its payroll supplier.
- *Maintain an employee dispute log*. If employees complain that there are problems with their pay, include this information in a dispute log and examine it regularly. This information is useful for uncovering problems in the payroll system.

Additional Payroll Controls – Related Activities

The payroll staff may also be involved in the payment of advances to employees, as well as their repayment through payroll deductions, and the calculation of accrued vacation benefits. The following controls address these additional payroll activities:

- *Prior approval of advances*. Always obtain supervisor approval before paying an employee advance. This is needed, since an advance is essentially a transfer of company assets to a third party, and if it is not paid back, the manager's department is charged the amount of the unrecovered funds.
- *Review advances made*. Require that all advances be recorded in a designated asset account, and have someone review the contents of the account regularly and follow up on outstanding amounts.

> **Associated Policy:** There should be a company policy to require immediate repayment of employee advances, which mitigates the risk that someone will leave the company before paying it back. The policy could be: *All employee advances shall be repaid in full in the payroll immediately following payment of the advances*.

- *Verify vacation roll-forward calculations*. Have a second person review the vacation roll-forward calculations at the end of each year. A second person is more likely to spot errors than the person who originated the calculations.
- *Review vacation accruals*. Schedule at least a quarterly review of all vacation calculations, during which you verify calculations that have changed recently, such as new vacation accruals for those employees reaching anniversaries that trigger new vacation rates.

> **Associated Policy:** Managers may be tempted to offer new hires unusual vacation terms in order to sweeten an employment offer. This causes major calculation problems for the payroll staff, so it is better from the accounting perspective to have a standard vacation policy, such as: *Vacation shall be ten business days per year for the first two years, followed by one additional day per year in each successive year, with a cap of twenty business days per year*.

Additional Accounting Policies

One additional accounting policy is that employees be required to certify (i.e., sign) their time sheets. This applies in situations where a company is working on a government contract, and the government requires that employees certify their timesheets. This policy is not needed in most other situations.

Summary

This chapter has outlined dozens of possible payroll controls. However, this does not mean that you should implement all of them in an excess of enthusiasm. There is a significant potential for the sheer volume of controls to overwhelm payroll processing. This is not a minor issue, since payrolls are processed within extremely tight deadlines, and pay must be issued by specific pay dates. Consequently, it is necessary to judge which controls are most likely to catch errors or fraud in comparison to their cost and general level of annoyance for the payroll staff.

Generally speaking, an entirely manual payroll process needs more controls, since it presents a higher risk of errors in the areas of data aggregation, data entry, and pay calculations. To avoid these risks and related controls, automate as much of the front-end of the payroll process as possible, and consider shifting the payroll processing and payment steps to a supplier. These system upgrades can result in the elimination of a number of controls.

Chapter 14 – Review Questions

The review questions accompanying this course are designed to assist you in achieving the course learning objectives. The review section is not graded; do not submit it in place of your qualified assessment. While completing the review questions, it may be helpful to study any unfamiliar terms in the glossary in addition to course content. After completing the review questions, proceed to the review question answers and rationales.

27.   A payroll data entry control is to:

    a.   Review gross pay calculations
    b.   Review the preliminary payroll register
    c.   Secure check printing equipment
    d.   Match entered totals to timesheets

28.   A separate bank account is used:

    a.   To fund direct deposit payments
    b.   To fund cash payments
    c.   To fund pay card payments
    d.   For payroll to keep someone from cashing a paycheck that was fraudulently created or altered

Chapter 15 – Fixed Asset Controls

Learning Objectives
After completing this section of the course, you will be able to:
- Identify the controls used to monitor, value, and report on fixed assets.

Introduction
Fixed asset accounting is substantially different from most of the transaction-based processes that have been described in the preceding chapters. It is unique in that the various processes related to it may be widely separated in time, with the eventual disposal of an asset occurring many years after its acquisition. Also, there are accounting processes that are entirely involved with meeting the dictates of accounting standards (such as depreciation and impairment), which has generally not been the case for most of the other business transactions described earlier in this book.

Given these differences, we are presenting fixed asset controls in the order in which they are used over the life cycle of a fixed asset, rather than during the stages of an individual process. In all other respects, the layout of this chapter is the same as those you have seen before – we give an overview of the fixed asset life cycle, describe process-specific controls, address those controls most likely to be needed, and conclude with a discussion of additional controls and related policies.

Related Podcast Episode: Episode 15 of the Accounting Best Practices Podcast discusses fixed asset controls. It is available at: **accountingtools.com/podcasts** or **iTunes**

For a complete discussion of fixed asset accounting topics, see the author's *Fixed Asset Accounting* book.

Fixed Asset Process Overview
Unlike many of the other chapters in this book, we cannot treat fixed asset accounting as a single process. Since there are several processes involved that may be separated from each other by many years, we will instead describe each step in the fixed asset life cycle, which are initial acquisition, subsequent valuation, and the eventual asset disposal. We have added an additional process to the fixed asset life cycle, which is the calculation of depreciation. A narrative description of these processes follows.

1. Fixed Asset Acquisition
When someone wants to buy a fixed asset, they submit an application form to management that describes the asset, the reasons for buying it, and the cash flows associated with it. Depending on the cost of the asset, there may be several approvals required, after which the form is sent to the purchasing department. The purchasing staff issues a purchase order to authorize the purchase of the asset. Once the fixed asset is received, the accounting staff records the transaction as a fixed asset, at its initial acquisition cost. However, if the cost of the asset falls below the company's capitalization limit, the expenditure is instead charged to expense. The capitalization limit is the amount paid for an asset, above which a business records it as a long-term asset. If the business

pays less than the capitalization limit for an asset, the expenditure is instead charged to expense in the period incurred.

2. Fixed Asset Depreciation

Once the fixed asset has been recorded in the accounting records, the accounting staff sets up a standard depreciation journal entry for it, based on its original cost, expected useful life, and any expected salvage value. The expected useful life and depreciation method used are typically based on the asset class to which a fixed asset is assigned. This recurring entry continues to reduce the net book value of the asset over its useful life.

3. Fixed Asset Valuation

The accounting staff periodically conducts asset impairment reviews to see if the cost of the fixed asset is higher than its fair value. If so, the asset is written down to its fair value. In addition, the accounting staff periodically determines if there is an asset retirement obligation that must be recorded for the asset. An asset retirement obligation is a liability associated with the eventual retirement of a fixed asset, such as paying to dismantle a facility once its useful life has been completed.

4. Fixed Asset Disposal

When it is time for an asset to be disposed of, management reviews the situation to determine the best form of disposition and has the purchasing department handle it. If there is a cash receipt related to the disposition, the accounting department records the receipt. No matter what the form of disposition, the accounting staff removes the ending balances for the fixed asset and any related accumulated depreciation from the accounting records.

The general flow of these fixed asset activities, including the associated paperwork, is noted in the following flowchart.

Fixed Asset Life Cycle

```
                    ┌─────────────────┐
                    │   Requester     │
                    │ completes fixed │ - - - - - - - - ┐
                    │ asset application│                 ▼
                    │      form       │        ┌─────────────────┐
                    └─────────────────┘        │   Fixed asset   │
                            │                  │ application form │
                            ▼                  └─────────────────┘
                    ┌─────────────────┐                 │
            ┌ - - - │   Purchasing    │ ◄ - - - - - - - ┘
            ▼       │ department issues│
    ┌─────────────┐ │ purchase order  │
    │  Purchase   │ └─────────────────┘
    │   order     │         │
    └─────────────┘         ▼
            │       ┌─────────────────┐
            └ - - ► │  Upon receipt,  │
                    │ accounting staff│
                    │ records the fixed│
                    │     asset       │
                    └─────────────────┘
                            │
                            ▼
                    ┌─────────────────┐
                    │Accounting staff │
                    │ sets up recurring│
                    │depreciation entry│
                    └─────────────────┘
```

Accounting staff conducts periodic impairment test

Accounting staff records any asset retirement obligations

Purchasing department disposes of asset

Cash received?

Accounting staff records cash receipt — Yes

No

Accounting staff removed asset from accounting records

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In-Process Fixed Asset Controls

In this section, we cover the controls that can be imposed on the various stages of the fixed asset life cycle. In addition, refer to the Additional Fixed Asset Controls sections for other controls that are positioned outside of the basic fixed asset transactions.

1. Fixed Asset Acquisition

The key focus of controls for the acquisition of key assets is to ensure that the company needs the assets. This means that controls are designed to require an evaluation of how a proposed acquisition will fit into the company's operations, and what kind of return on investment it will generate. A secondary set of controls are also needed to ensure that all acquisition transactions are forced to follow this review process. With these goals in mind, consider using the following controls:

- *Require an approval form*. There should be an approval form that requires an applicant to describe the asset, how it is to be used, and the return on investment that will be generated (if any). This standardizes the information about each fixed asset, and also provides a handy signature form for various approvals.

> **Associated Policy:** There should be a corporate policy that requires the submission of an approval form for any fixed asset request. A sample policy is: *Employees must submit a capital budgeting request for any asset purchase exceeding the corporate capitalization limit.*

- *Require independent analysis of the approval form*. Someone who is skilled in asset analysis should review each submitted approval form. This analysis includes a verification that all supporting documents are attached to the form, that all assumptions are reasonable, and that the conclusions reached appear to be valid. The person conducting this analysis does not necessarily render an opinion on whether to acquire the asset, but should point out any flaws in the proposal. This person should *not* report to the person who submitted the proposal, since that would be a conflict of interest.
- *Require multi-level approvals for more expensive assets*. If an asset request is *really* expensive, impose a requirement for a number of approvals by people in positions of increasing levels of authority. Though clearly time-consuming, the intent is to make a number of people aware of the request, so that the organization as a whole will be absolutely sure of its position before allowing a purchase to proceed.
- *Focus more attention on rush requests*. Someone may try to avoid the usual review steps in order to obtain an asset right now on a rush basis. These are precisely the sorts of situations where it may make sense to impose a tighter review, since the rush nature of the purchase may be keeping people from due deliberation of the alternatives available. The exact nature of this control will vary under the circumstances, but the key point is to not eliminate *all* reviews and approvals just because someone says that an asset must be bought at once.
- *Impose a mandatory waiting period*. Though controversial, it may make sense to impose a waiting period before any asset is purchased, on the grounds that due deliberation may reveal that some assets are simply not needed, and so should not be bought. Taken to extremes, such a control can result in an excessively plodding organization, so use it with care.

- *Do not issue a purchase order without a signed approval form*. Train the purchasing staff to not order fixed assets unless the requestor has a signed approval form. Better yet, route all such purchase orders to a senior executive, such as the chief financial officer, for approval.
- *Assign a monitoring cost accountant*. For a really large project, there should be a designated person who is responsible for tracking the costs accumulating against the project, and reporting this information to management. This person also decides when to shift a project out of the construction-in-progress account and into a regular fixed asset classification. The ideal person for this task is a cost accountant, since this position is trained in cost accumulation and analysis.
- *Conduct milestone reviews*. For longer-term asset installations, there should be a series of milestone events at which the management team responsible for the project examines expenditures to date, progress on the project, and any issues relating to the remaining tasks to be completed. Though rare, the team may occasionally use the information obtained in this review to cancel the project entirely. A more common response is a variety of adjustments to improve the odds of successful completion within the cost budget.

> **Associated Policy:** A policy can be used as the basis for an ongoing system of reviewing fixed asset installations. For example: *The results of all capital purchases in excess of $___ shall be reviewed and reported to management within __ months of final installation.*

The controls noted here will absolutely slow down the fixed asset acquisition process, and with good reason – part of their intent is to encourage more deliberation of why an asset is being acquired. Nonetheless, these controls will appear onerous to those people trying to obtain assets that are relatively inexpensive, so it is certainly acceptable to adopt a reduced set of controls for such assets, perhaps simply treating them as accounts payable that require a single approval signature on a purchase order.

Similarly, you can consider a more streamlined set of controls for assets that must be acquired at once. However, keep in mind that some managers intent on subverting the system of controls can characterize *everything* as a rush requirement, just to avoid the usual reviews and approvals. Consequently, if a reduced set of controls is adopted for such purchases, at least conduct an after-the-fact review of the circumstances of these purchases, to see if the reduced controls were actually justified.

2. Fixed Asset Depreciation

Depreciation calculation errors are extremely common, since there are opportunities to incorrectly enter the asset amount, useful life, salvage value, and depreciation method in whatever calculation spreadsheet or software is being used. Here are several controls that can mitigate this problem:

- *Conduct separate review of master file additions*. Have a second person review any records added to the fixed asset master file. This review should involve a comparison of the amounts paid to the amount listed in the master file, to ensure that the amount being depreciated is correct. Also, verify that the asset classification in which each asset is placed is the correct one, since this usually drives the depreciation method used and the

useful life over which it will be depreciated. Further, verify that any salvage value used has been properly substantiated. Finally, verify that the recorded asset location is correct, so that anyone attempting to locate the asset in the future will be able to find it.

- *Audit depreciation calculations*. Have the internal audit staff periodically review a selection of the depreciation calculations, to see if an asset is being depreciated over the correct useful life, with the correct depreciation method, and with a verifiable salvage value. Errors will be more common if this information is being maintained on an electronic spreadsheet, given the greater risk of manual errors in this format.

3. Fixed Asset Valuation

Fixed assets gradually lose their value over time, so controls are needed to monitor what they are worth. The results of these controls may lead to further actions. The controls are:

- *Conduct asset impairment reviews*. Generally accepted accounting principles mandate that you write down the book value of a fixed asset if the value of the asset falls below its book value. To do this, you need a regularly scheduled valuation review, possibly involving the services of an outside appraisal firm.

> **Associated Policy:** Impairment reviews have a way of not being done, so use a policy to enforce their completion. A sample policy is: *All fixed assets having a gross carrying amount greater than $___ shall be tested for impairment at least once a year, or when it appears that the carrying amount may not be recoverable.*

> **Tip:** Asset impairment reviews can be quite expensive, both in terms of staff time and the cost of appraisers, so only review the most expensive fixed assets. There is only a small potential valuation decline in lower-cost assets, so there is no point in reviewing them. The cutoff point for conducting an asset impairment review may be much higher than the capitalization limit used to record fixed assets. For example, the capitalization limit might be $5,000, while the impairment review cutoff might be $100,000.

- *Use appraisers to value dissimilar exchanges*. The accounting standards allow a business to record a gain or loss on the difference in value of dissimilar assets if they are exchanged with a third party. Since fair value can be a matter of opinion, this can result in the creation of an artificial gain or loss. Consider using the valuation services of an outside appraisal firm to eliminate this problem.

> **Tip:** Outside appraisal firms are expensive, and do not provide value to a company that actually improves its profits. Instead, they simply give an impartial and presumably expert opinion of asset values that can be used to improve the accuracy of accounting records. Consequently, if there is a choice of using an internal or external appraisal, use the internal one for assets that cannot possibly have a large valuation anyways; any difference in value that an outside appraiser would provide would not be worth the cost of their services in these cases.

> **Associated Policy:** A policy can restrict the use of appraisers to higher-cost assets. A sample policy is: *An independent appraiser shall determine the value of assets received as part of a non-monetary exchange, if the estimated value of the assets received exceeds $___.*

- *Conduct a periodic review for asset retirement obligations*. Asset retirement obligations (AROs) are relatively rare, but the associated liability can be quite large. Consequently,

conduct a periodic review to see if there may be any larger AROs that should be recorded.

> **Tip:** The accounting for AROs is complex, so do not waste time tracking AROs in immaterial amounts. Instead, adopt a cutoff liability level below which AROs are not to be recorded.

4. Fixed Asset Disposal

There tends to be a certain amount of fixed asset "leakage" out of a company, especially for smaller and more mobile assets, such as computers. In many cases, the resale value of these items near the end of their useful lives is so small that a company may very well be justified in giving them away to employees or simply dropping them into the scrap bin. However, there may be some residual value remaining in certain assets, so consider using the following controls to recapture some of that value:

- *Conduct asset disposition reviews*. The goals of this review are to decide whether a company continues to need a fixed asset, and if so, how to obtain the highest price for it. If this control is not used, assets tend to remain on the premises long after they are no longer needed, and lose value during that time. The best group for conducting this analysis is the industrial engineering staff, since they are responsible for the production layout, and most fixed assets are located in this area.
- *Require signed approval of asset dispositions*. Create a form that describes the asset to be disposed of, the method of disposition, and the cash to be received (if any). The person whose authorization is required could be a specialist in asset disposition, or perhaps the purchasing manager, who might have some knowledge of asset values. The point of this control is to require a last look by someone who might know of a better way to gain more value from a disposal.
- *Monitor cash receipts from asset sales*. Most fixed assets are sold for cash, and sometimes for large amounts of cash. Given the amount of funds involved, it can be quite a temptation for employees to find ways to either not record asset sales or falsify sale documents to record smaller sales, and then pocket the undocumented cash. You can monitor this by requiring that a bill of sale from the purchasing entity accompany the documentation for each asset sale. It is also useful to periodically audit asset sale transactions, if only to show the staff that these transactions are being monitored.
- *Send copy of disposal form to accounting*. If there is an asset disposal form that must be filled out prior to the disposal of a fixed asset, route a copy of it to the accounting department, so that the accounting staff can write off the asset and stop recording a periodic depreciation charge for it.

Alternative Fixed Asset Control Systems

In this section, we highlight the core group of controls that should be applied to most types of fixed assets. In nearly all cases, the applicant should complete a fixed asset approval form, which is reviewed by another party, such as the corporate financial analyst. Without these two controls, there is a danger that relatively expensive fixed assets will be purchased without much consideration of why the company needs them. In addition, a cost accountant should be assigned to the more expensive asset purchases to monitor their costs as they are acquired, installed, and brought on line.

The key controls for depreciation are to ensure that each asset is assigned to the correct asset class (since certain useful lives and depreciation methods may be used for each class), and that depreciation calculations are audited.

The valuation of most smaller fixed assets is not monitored, since it is not cost-effective to examine impairment issues for fixed assets hovering around a company's capitalization limit. However, more expensive fixed assets require the use of periodic impairment testing and examinations regarding any asset retirement obligations.

Finally, it is essential to obtain formal approval for the disposition of all fixed assets, as well as to monitor any resulting cash receipts, since this is a prime area in which asset theft can occur. Also, the accounting staff should be notified of all dispositions, so that it can eliminate the associated assets from the accounting records and record a gain or loss on each transaction.

These controls are noted in the following control chart, where controls are clustered under the basic stages in the fixed asset life cycle.

Core Controls for the Fixed Asset Life Cycle

1. Fixed asset acquisition

> Require fixed asset purchase approval form

> Require independent analysis of each request

> Assign a monitoring cost accountant

2. Fixed asset depreciation

> Verify designation of assigned asset class

> Audit depreciation calculations

3. Fixed asset valuation

> Conduct asset impairment reviews

> Review for asset retirement obligations

4. Fixed asset disposal

> Require approval of asset dispositions

> Monitor cash receipts from asset sales

> Send disposal form to accounting

For the core controls, we assume that the assets being purchased are high-cost items that require the assignment of a monitoring cost accountant, as well as periodic impairment testing and reviews for asset retirement obligations. These controls are not necessary for lower-cost fixed assets.

Additional Fixed Asset Controls – Fraud Related

Fixed assets may have a significant resale value, which makes the more portable ones subject to theft. Here are several controls that can be of assistance in preventing or at least mitigating asset losses due to theft:

- *Use prenumbered approval forms*. Someone may try to forge the signatures on a fixed asset approval form, so consider using prenumbered forms. Also, store them in a locked cabinet, and keep track of all forms taken from the cabinet. This control may be overkill – after all, the presumed penalties for being caught with a forged approval form would likely deter most people.
- *Segregate fixed asset responsibilities*. You are making it much easier for an employee to steal an asset if that person is given complete responsibility over all aspects of asset purchasing, recordation, and disposal, since they can alter documents at will. Consequently, the person who receives a fixed asset should not be the same person who records the transaction, while the person who disposes of an asset cannot also record the sale. Further, the person who audits fixed assets should not be involved with fixed assets in any other way.
- *Lock out the fixed asset master file*. Depending on the nature of an organization's accounting systems, there may be a fixed asset master file in which detailed information about every fixed asset is kept. If someone were to steal a fixed asset, they could cover all traces of the act by removing the asset from the master file, or at least altering it. Consequently, password access to this file should be required.
- *Restrict access to assets*. If some assets are especially valuable and can be easily removed from the premises, restrict access to them with a variety of security card access systems, gates, security guards, and so forth.
- *Assign assets to employees*. If you assign responsibility for specific assets to employees and tie some portion of their annual performance appraisals to the presence and condition of those assets, that represents a built-in asset monitoring system. This control works best at the department level, where department managers are assigned responsibility for the assets in their areas. Also, create a system that issues a periodic report to each responsible person, detailing the assets under their control, and reminding them to notify a senior manager if any assets are missing. Further, if responsibility for assets is shifted from one person to another, there must be a process for doing so, where the newly-responsible person formally evaluates the condition of the asset and takes responsibility for it.
- *Look for duplicate serial numbers*. Though rare, it is possible that employees may be stealing fixed assets from the company and selling them back through a dummy corporation. To detect this, enter the asset serial number in the fixed asset record for each asset, and then run a report that looks for matching serial numbers. If a duplicate number is found, this means that an asset was stolen and sold back to the company.
- *Conduct a fixed asset audit*. Have an internal auditor conduct an annual audit of all fixed assets to verify where they are located, the condition they are in, and whether they are still being used.

> **Tip:** If the auditors search for every fixed asset in a company's accounting records, the audit may be prolonged. To shorten it, concentrate on the 20 percent of assets that usually make up about 80 percent of the total cost of all fixed assets, with a spot check of other assets falling outside this key group.

> **Associated Policy:** A formal policy can mandate a periodic fixed asset audit. A sample policy is: *An annual audit of all fixed assets exceeding a gross cost of $___ shall be conducted, and the results communicated to management.*

- *Affix an identification plate to all assets*. Solidly affix an identification plate to any fixed asset that can be moved, so that it can be clearly identified. Better yet, engrave an identification number into the asset, which eliminates the risk of someone removing the identification plate. Another alternative is to affix a radio frequency identification (RFID) tag to each asset, so that they can be more easily located with an RFID scanner. If any form of identification tag is used, be sure to record the unique number on each tag in the appropriate asset record, so that the information in the record can be traced back to the actual asset.
- *Link RFID tags to alarm system*. Install an RFID scanner next to every point of exit, which will trigger an alarm if anyone attempts to remove an asset that has an RFID tag attached to it. RFID is a contraction of the term "radio frequency identification," and involves the use of either passive or active radio transmission chips to track the location of assets.

Additional Fixed Asset Controls – Periodic Actions
The following controls are mostly detective controls that spot problems after they have occurred. They are not necessarily part of a specific process; instead, the accounting staff schedules them as separate tasks. These controls are:

- *Reconcile fixed asset additions to approval forms*. If asset purchases are allowed without an authorizing purchase order, compare all additions listed in the fixed asset general ledger accounts to the signed approval forms, to see if any assets were bought without approval. This is an after-the-fact control, since an asset will have already been bought, but proper education of the responsible party can prevent such purchases from happening again.
- *Review expense accounts for fixed assets*. It is possible that smaller fixed assets may have been inadvertently charged to expense. If so, they are probably located in one of the supplies, maintenance, or repairs expense accounts. The accounting staff can review these accounts from time to time to see if this is the case, and reclassify them as fixed assets.

> **Tip:** Fixed assets that were charged to expense probably have such low costs that reclassifying them as fixed assets will have little overall impact on the financial statements. Consequently, this review can be completed at long intervals.

- *Concentrate asset analyses in an annual review process*. When you review asset purchase requests at varying intervals throughout the year, you have no basis of comparison against other asset purchase proposals, and so will be less likely to turn down the requests. An alternative approach is to have a formal, annual review of these requests, where you can compare and contrast them and see which ones make the most sense. Though it may appear excessively bureaucratic, this approach can prevent a company from a number of unnecessary expenditures.

> **Tip:** A centralized fixed asset review process does not necessarily work if a business does not subscribe to the concept of an annual budgeting process. See the author's *Budgeting: A Comprehensive Guide* for more information.

- *Review the accuracy of depreciation calculations*. If depreciation is being calculated manually, there is a good chance that there are inaccuracies in some elements of the calculations. Thus, the accounting staff should review the accuracy of these calculations from time to time.

> **Tip:** When reviewing depreciation calculations, pay particular attention to those assets added since the last depreciation review, as well as to the oldest assets that are nearing the end of their useful lives. In the latter case, there is a good chance that depreciation has continued past the designated useful life, so that too much depreciation has been charged to expense.

- *Report to management on fixed asset additions and disposals*. This is a standard monthly report that states what was purchased and at what price, and what was disposed of and at what price. The report may also detail any fixed asset transfers between departments. The intent of the report is simply to bring fixed asset activity to the attention of management; it will hopefully prompt commentary from managers regarding the status of fixed asset transactions.
- *Compile a fixed asset roll forward*. This report is commonly requested by auditors as part of their year-end audit procedures, and is also useful for reconciling the balances in the various fixed asset and accumulated depreciation accounts. In essence, the report starts with the beginning balances in each relevant account, and adds or subtracts subsequent changes to each account to arrive at the ending account balances. Each number in this report should tie back to the underlying fixed asset accounts.

Additional Accounting Policies

There are several supplemental accounting policies that were not mentioned earlier in association with specific controls. These policies are:

- *The corporate capitalization limit is $___. Any expenditure above this amount where the asset has a useful life of at least one year is to be classified as a fixed asset.* This policy is designed to keep smaller expenditures from being recorded as fixed assets, thereby reducing the record keeping required of the accounting staff.
- *Salvage value shall be set at zero for all depreciation calculations, unless the expected amount of salvage value is at least $___.* This policy is designed to reduce the complexity of depreciation calculations, which may be of concern when depreciation is calculated manually.
- *The written approval of both the issuing and receiving managers are required for the transfer of fixed assets. The accounting department shall be notified of all fixed asset transfers.* This combination policy is designed to ensure that a company does not lose track of any fixed assets that are shifted between departments.
- *A detailed accounting and asset condition record shall be created and maintained for each fixed asset acquired, which shall include information about the assessed value, classification, cost, depreciation method, easements, impairment, location, supplier, useful life, warranties, and zoning associated with the asset.* The level of record keeping is much higher for fixed assets than it is for normal expenditures that are charged to

expense. This policy is perhaps too detailed, but makes the point that a large amount of information should be stored about each fixed asset.

- *Original title documents shall be stored in certified fire-proof bank vaults. Copies of purchase and disposal documents shall be maintained in off-site fire-proof storage facilities.* This policy is designed to ensure the safety of the more critical documents associated with fixed assets.

Summary

This chapter has outlined a large number of fixed asset controls. It requires judgment to decide how many of them to use, since an excessive level of control is burdensome, while minimal controls lead to profligate spending and lost assets. The answer to this conundrum usually lies in the nature of the assets themselves. For example, a hydroelectric company is incredible unlikely to lose its turbines, and so can dispense with most of the controls related to asset theft for those items. On the other hand, given the massive cost of turbines, it needs an exceptional level of control over its purchases. Conversely, a company whose only fixed assets are laptop computers should seriously consider treating them as office supplies, given how difficult it would otherwise be to keep track of them, and how inexpensive they are to replace. Thus, it is necessary to tailor fixed asset controls to the circumstances.

Chapter 15 – Review Questions

The review questions accompanying this course are designed to assist you in achieving the course learning objectives. The review section is not graded; do not submit it in place of your qualified assessment. While completing the review questions, it may be helpful to study any unfamiliar terms in the glossary in addition to course content. After completing the review questions, proceed to the review question answers and rationales.

29.   An audit of depreciation calculations addresses the following, **EXCEPT** for:

   a.   The useful life
   b.   The depreciation method
   c.   The salvage value
   d.   The accounts to which depreciation is charged

30.   Controls over asset disposals include the following, **EXCEPT** for:

   a.   Disposition reviews
   b.   Reviews for asset retirement obligations
   c.   Monitoring of cash receipts from sales
   d.   Signed supervisor approvals of disposals

Chapter 16 – Treasury Controls

Learning Objectives
After completing this section of the course, you will be able to:
- State the controls used for cash forecasting, funds transfers, stock issuances, and collateral monitoring.

Introduction
Treasury is responsible for a number of forecasting, investment, and fund raising activities. Since they are largely separate activities, we will deal with each one in a separate section. We address cash forecasting first, since the information provided by it is the foundation for the other investing and fund raising activities noted later in the chapter. We also describe investing activities, obtaining debt, and selling stock. In each case, we describe a range of possible controls, the minimum set of allowable controls, and supporting policies.

> **Related Podcast Episode:** Episode 170 of the Accounting Best Practices Podcast discusses treasury controls. It is available at: **accountingtools.com/podcasts** or **iTunes**

The Cash Forecasting Controls Environment
The treasury staff compiles a cash forecast, which it uses to estimate the cash requirements of the business for the upcoming period spanning the duration of its usual investment instruments and short-term debt. A comprehensive cash forecast can be an elaborate undertaking, since it requires inputs regarding the following cash-related issues:
- Expected cash receipts from customer billings (Source: Collections manager)
- Expected cash receipts from the sale of assets (Source: Controller)
- Expected cash receipts from gains on invested funds (Source: Treasury department)
- Expected cash outflow for payroll payments (Source: Payroll manager)
- Expected cash outflow for supplier payments (Source: Accounts payable manager)
- Expected cash outflow for interest expense (Source: Treasury department)
- Expected cash outflow for dividend payments (Source: Corporate secretary)
- Expected cash outflow for acquisitions (Source: Acquisitions department)
- Expected cash outflow for fixed asset purchases (Source: Controller)
- Expected cash outflow for tax payments (Source: Tax manager)

There are clearly many systems from which information must be drawn, which makes it difficult to consistently create an accurate forecast. The following controls are useful for improving the accuracy of the forecast:
- *Use a cash forecast checklist*. If the cash forecast is updated at fairly long intervals, or if responsibility for preparing it is shifted among several people, it is possible that some elements of the forecast will be inadvertently excluded from time to time. This risk can be mitigated by enforcing the use of a standard checklist of actions to take when constructing the forecast.
- *Verify the accuracy of cash forecasts*. It is impossible to have an investment strategy if the cash forecasting system is inaccurate. Consequently, the treasurer should routinely compare the actual cash position to what had been forecasted, and adjust the forecasting model accordingly.

- *Obtain additional cash forecast reviews.* If there is a great deal of investment reliance on the cash forecast, consider having several people review it. For example, the collections manager can provide the best estimates of cash receipts, while the accounts payable manager and payroll manager have the best insights into expected cash disbursements.
- *The corporate secretary warns the treasurer of approved dividends.* The board of directors must authorize dividends, so any such authorizations will be documented in the board minutes by the corporate secretary. The treasurer should be on the standard mailing list for board minutes, so that he or she will be made aware of any dividends that should be incorporated into the cash forecast.
- *The treasurer is informed of capital purchase plans.* The treasurer should be made aware of all changes to the capital budget, and in particular of all short-notice purchases of fixed assets, since these acquisitions can have a considerable negative impact on the cash forecast.
- *The treasurer is informed of acquisition discussions.* An acquisition can be the largest use of cash that a company ever experiences, so the treasurer should be brought into all discussions regarding possible acquisitions and the amounts to be paid in cash. Reasonably probable acquisitions should be factored into the cash forecast.

The minimum set of controls likely to be needed for a cash forecasting system are:
- Use a cash forecast checklist
- Verify the accuracy of cash forecasts

These two controls are sufficient for the day-to-day maintenance of a cash forecast model that is well-established, and which experiences few unexpected changes over time. As the business environment becomes more volatile, the other controls should be added to maintain a high level of forecasting accuracy.

The cash forecast stands at the center of many decisions made by the treasury department, so it must be not only as accurate as possible, but also updated frequently enough to provide reliable forecasts to the treasury staff. The following policies address these issues:
- *A cash forecast shall be used as the basis for funds planning.* It is impossible to invest funds in longer-term investments without a reliable cash forecast. Otherwise, the treasurer is forced to invest solely in very short-term investments that usually carry lower interest rates. Conversely, there is great risk in placing funds in longer-term investments without the foreknowledge provided by a quality cash forecast.
- *A new cash forecast shall be issued on at least a [time period] basis.* The treasury staff should be required to issue cash forecasts with great regularity. This policy sets the minimum interval for issuing new forecasts.
- *The construction of the cash forecast shall be examined annually.* The spreadsheet used to construct a cash forecast may become outdated as a business changes, so there should be a mandatory examination of the spreadsheet itself, to see if it still generates an accurate forecast.

> **Tip:** The cash forecast should also be revised when the company is restructured, such as when there is a divestiture or acquisition.

The Funds Investment Control Environment
The treasury staff uses the information in the cash forecast to estimate the amount of cash that it can invest, and the duration over which it can invest the funds. It is generally possible to obtain a higher rate of interest if a business is willing to invest for a longer duration, though there is a risk that the cash may be needed before the investment has matured.

The treasury staff recommends on an investment approval form the types of investments to which it would like to allocate funds during the cash forecasting period. If the treasurer approves the recommended investments, the staff invests the cash as planned.

Since a high-risk investment can potentially destroy the invested cash of a business, it is imperative that a strong set of controls be implemented to limit the types of investment vehicles used. Also, since investment activities involve shifting large amounts of cash outside of a business, there is some risk of fraud. The following controls address these and other issues:

- *Use standard investment guidelines*. The treasury staff should make all investments based on a standard investment policy that restricts them to certain types of investments. This reduces the chance of placing funds with an unduly risky or long-term investment vehicle.
- *Verify that the proposed investments do not exceed the period of the cash forecast*. It would be unwise to engage in any investment from which the company cannot extract itself within the term of its cash forecast. Otherwise, if cash flows decline after the latest forecasted date, the company might have to borrow funds to meet its operating needs until such time as the investment reaches its maturity date.
- *Obtain interest rate quotes*. If the company invests its short-term funds through banks, have the treasury staff complete an interest rate quote sheet on which they formally document the interest rates quoted to the company by several banks.
- *Use a standard investment authorization form*. All proposed investments should be included on a standard form that includes a required authorization signature. This provides documentation that all investments made were properly authorized.

> **Tip:** If interest rate quotes were obtained, they should be attached to the investment authorization form as proof that the highest-return investment is being obtained within the standard investment guidelines.

- *Use workflow systems for treasury transactions*. If there is sufficient treasury volume to justify the cost, install a treasury management system that routes treasury transactions to the authorized parties for such transactions as authorizing or rolling over investments.
- *Obtain transaction receipts*. No matter what type of investment the treasury staff purchases, be sure to obtain a receipt for it, and staple the receipt to the original investment authorization form.
- *Match receipts to authorization form*. Someone not directly involved in investment activities should reconcile interest rate quotes to investment authorization forms and investment receipts, and report any unexplained variances to the treasurer.
- *Match interest rate quote to actual interest rate paid*. Someone should match the quoted interest rate to the amount actually paid by the bank, and bring variances to the attention of the treasurer.

> **Tip:** If a bank has a history of bidding one investment rate and paying a lower one, that bank should be removed from the company's approved list of banks.

- *Reconcile actual funds transfer transactions to authorized transactions*. Have a person not involved in funds transfers review all electronic funds transfers from the previous day, and see if any occurred that were not listed on the authorized funds transfer or investment form.

> **Tip:** This reconciliation should take place as soon as possible each morning for the previous day's transactions, while there may still be time to reverse the transactions (though only if they are ACH transactions – wire transfers are usually settled in minutes).

- *Update valuations*. Update the recorded valuations of all investments at the end of each reporting period. Otherwise, reported investment balances may be incorrect.
- *Reconcile recorded investment balances to amounts stated by third parties*. Someone not involved in the transfer of funds should reconcile the recorded amount of cash invested to the month-end statements provided by those third parties with whom the company has invested its funds.
- *Treasurer reviews and approves all treasury-related journal entries*. The treasurer should review the justification for every transaction related to cash transfers, investment valuations, the recognition of gains and losses, and so forth, and approves the related journal entries.
- *Treasurer reviews investment ending balances and disclosures*. The treasurer should review and approve the ending valuations of investments, as well as all associated disclosures and both recognized and unrecognized gains and losses.
- *Treasurer reviews and approves financial statement disclosures*. The treasurer should review and approve all treasury-related disclosures that are included in the financial statements.
- *Verify that actual investments comply with investment limitations*. If there is a policy defining the types of investments that the company is allowed to engage in, there should be a periodic comparison of actual investments to this policy, to ensure that the treasury staff is in compliance with the policy.

There are a large number of investment-related policies that are mostly intended to restrict the range of possible investments that the treasurer is allowed to engage in. Examples of what these policies could look like are:
- *Investments shall be restricted to [investment classification]*. This policy is designed to keep the treasury staff from investing funds in investments that have inordinately high levels of risk or low levels of liquidity.
- *The maximum investment maturity shall be [months]*. This policy is designed to keep a company's funds as liquid as possible. Even though this policy may keep the treasurer from investing in higher-return investments, liquidity is usually considered to be a significantly more important goal to pursue.
- *At least [days of working capital] shall be invested in completely liquid investments*. This is a sample of a policy designed to ensure that an adequate proportion of a company's likely cash requirements will be stored in immediately accessible investment funds.

- *Overnight investments shall only be made with a list of approved banks*. This policy keeps the treasury staff from investing funds in banks having less robust finances.

The preceding and rather hefty set of controls may all be used in a larger treasury department that handles large investments. In smaller organizations that only purchase short-term investments from a single bank, the following minimum set of controls may be sufficient:
- Use standard investment guidelines
- Obtain transaction receipts
- Reconcile recorded investment balances to accounts stated by third parties

This vastly reduced set of controls is only possible when the treasury department is so small that the treasurer is directly engaged in most transactions, and where most investments are extremely short-term and liquid. In this situation, there is less need for authorizations and reconciliations.

The following two policies are intended to restrict the number of people allowed to make investments, and to reduce the risk associated with the physical handling of securities:
- *The treasurer must authorize all investment transactions and funds transfers*. This policy is designed to introduce oversight into the transfer of what may be very large amounts of cash.
- *Securities shall be stored with an independent custodian*. Investment documents should be stored with an independent custodian, so there is never any risk that someone could steal securities. In practice, this is rarely an issue.

The Debt Procurement Control Environment
There are situations where there is so little cash on hand that the treasury staff is more concerned with obtaining debt than with investing excess funds. This may involve sending an authorization to the company's bank to draw down a line of credit, or arranging for a more formal long-term lending arrangement.

When there is a line of credit, the key control issues are that the treasurer be kept aware of the remaining available amount of unused debt, and that the amount of debt recorded on the company's books matches the amount recorded by the lender. These and other controls are as follows:
- *The treasurer approves line of credit drawdowns and repayments*. The treasurer should sign off on all changes in the company's line of credit.

> **Tip:** There should be a close linkage between maintenance of the cash forecast and expected debt changes, since these changes can have a major impact on the amount of cash available for investments.

- *Reconcile loan statement to the general ledger balance*. The treasury or accounting staff should reconcile any differences between the company's record of a loan balance and the loan balance indicated by the lender.
- *Compare collateral requirements*. The treasurer or corporate counsel should compare the terms of all debt agreements to see if the company has conflicting collateral requirements. It is entirely possible that more than one lender can claim the same assets as collateral.

This is not a minor issue, since some lenders have been known to terminate loan agreements because of conflicting collateral obligations.

- *The board of directors approves new loans or bonds*. Board minutes signed by the company secretary should state that the board of directors has formally approved of the issuance of loans or sale of bonds.
- *Report debt levels and terms to the board of directors*. Periodically report to the board of directors the amount of all debt outstanding, interest rates being paid, how long before the agreements terminate, and the prospects for renewal. The board needs to know if there is a prospect for having a sudden cash shortfall caused by a called loan or debt nonrenewal, so do not treat this control lightly.

In the typical small-company environment where there are perhaps one or two long-term loans and a line of credit, only the following two controls need to be rigorously followed:

- The treasurer approves line of credit drawdowns and repayments
- Reconcile loan statement to the general ledger balance

The following policy is designed to reduce the cost of debt:

- *The company shall retire its debt and replace it with lower-cost debt whenever the market interest rate and the current debt terms make this feasible*. This requirement to reduce the cost of debt may appear cost-effective, but is realistically only useful when the terms of the existing debt agreement allow a company to retire its debt prior to the termination date.

The Stock Issuance Control Environment

Of all the fund raising activities that a company engages in, the issuance of stock requires the most in-depth range of controls. There are significant liabilities associated with the incorrect issuance of stock certificates, so *all* of the following controls should be followed; there is no recommended reduced set of controls:

- *Verify that there are sufficient authorized shares*. There must first be a sufficient number of authorized shares available to sell. It can require shareholder approval to increase the number of authorized shares, so this is not a minor matter.

> **Tip:** There should be sufficient authorized shares available for the proposed stock sale *after* including the conversion effects of all outstanding warrants and stock options.

- *The board of directors approves the sale of all stock*. Board minutes signed by the company secretary should state that the board of directors has formally approved of the sale of stock.
- *Obtain accredited investor letter*. If the company is selling unregistered stock, it should first obtain from all purchasing individuals a letter stating that they are accredited investors.
- *Issue stock through a stock transfer agent*. There should never be any blank company stock certificates held on-site. Instead, hire a stock transfer agent to issue shares to shareholders at the direction of the corporate secretary.

- *Use a formal letter of direction to issue stock.* The stock transfer agent should be instructed to only issue stock as per the direction of the corporate secretary, who must sign a letter of direction that states the specifics of each share certificate to be issued.

> **Tip:** The stock transfer agent should have a copy on file of the corporate secretary's signature, which it uses to validate all letters of direction received from the company.

- *Reconcile cash received to letters of direction.* The treasurer should verify that a letter of direction has been issued that corresponds to cash received from investors to purchase stock.
- *Reconcile shareholder list to letters of direction.* The treasurer should periodically request a shareholder list from the stock transfer agent, and match changes in it to copies of the letters of direction previously sent to authorize the issuance of stock.

> **Tip:** This control will not always work if some stock is registered with the Securities and Exchange Commission, for stockholders can then place their shares with a broker, whose name will appear in their place in the records of the stock transfer agent.

- *Audit shareholder list.* The internal audit staff should verify that the number of shares outstanding, as supplied by the stock transfer agent, matches the company's internal shareholder list.

The custody and tracking of stock certificates is an important area, since someone could fraudulently earn a large amount by gaining access to a company's stock certificates and then selling them. The following control addresses this problem.
- *Stock certificates shall be issued by a stock transfer agent.* This policy is designed to shift the custody of all blank stock certificates to a third party custodian.

A publicly-held company can get into trouble with the Securities and Exchange Commission (SEC) if it issues shares that have not first been registered with the SEC. The following policy guards against this issue:
- *All unregistered stock sold shall contain a restrictive legend.* This policy is designed to restrict the ability of the buyers of a company's unregistered stock to sell their shares until various regulations promulgated by the Securities and Exchange Commission have been met.

Additional Treasury Controls – Fraud Related
There is a reasonable chance that fraud will occur in the treasury area, since it handles all of a company's cash. Accordingly, consider implementing the following controls to prevent or at least detect fraud:
- *Separation of duties.* The person who initiates a funds transfer cannot release or validate the transaction. This is a critical control, since someone could otherwise single-handedly shift large amounts of cash out of a business.

> **Tip:** If the treasury department is small, have the chief executive officer or chief financial officer release or validate the transfer of funds. This brings cash transfers to the attention of senior management.

- *Restrict use of authenticated computers.* A bank typically authenticates the security certificate associated with a particular computer, and then requires a company to initiate ACH and wiring instructions from that computer. If a third party can gain access to that computer, they can authorize funds transfers out of the company's bank account. This issue can be combatted by severely locking down use of the authenticated computer. This means that it is not used for web browsing or for email downloads, or any other activities by which someone could insert keystroke logging software onto the computer, and then use the resulting information to hack into and use the computer from a remote location.

> **Tip:** While all computers should be protected with a firewall and antivirus software, this is especially important for the computer used to initiate wire transfers.

- *Use a clearing account.* Arrange with the bank to only allow wire transfers and ACH transactions from a designated clearing account. Then fund this account with only sufficient funds to cover all transactions. Thus, the clearing account requires that someone fraudulently move funds into the clearing account before they can send the cash outside of the company. The two-step nature of the transaction makes it more difficult to commit fraud.

Summary

Several separate transactions were described in this chapter – investing funds, obtaining debt, and selling stock. All three transactions are based on the accuracy of the cash forecast, so it is imperative that there be a well-organized system in place for deriving the forecast, as well as a system for investigating variances between forecasted and actual results. Without an accurate cash forecasting system, the entire treasury function is rendered far less effective.

In addition to cash forecasting issues, a company should pay particular attention to its controls over investments. It is possible for someone to fraudulently transfer all of a company's cash to a distant bank account from which there is no hope of recovery. Thus, even if the probability of such an event is low, the risk of loss is so massively high that it is mandatory to position controls to prevent this type of fraud.

Chapter 16 – Review Questions

The review questions accompanying this course are designed to assist you in achieving the course learning objectives. The review section is not graded; do not submit it in place of your qualified assessment. While completing the review questions, it may be helpful to study any unfamiliar terms in the glossary in addition to course content. After completing the review questions, proceed to the review question answers and rationales.

31.   A useful control for higher-volume treasury transactions:

    a. Is a workflow system to route approvals to authorizing parties
    b. Is to use standard investment guidelines
    c. Is to use a standard investment authorization form
    d. Is to obtain investment transaction receipts

32.   In a smaller organization, the following treasury control is usually **NOT** required:

    a. Use standard investment guidelines
    b. Obtain transaction receipts
    c. Reconcile investment book balances
    d. Obtain interest rate quotes

Chapter 17 – Financial Reporting Controls

Learning Objectives
After completing this section of the course, you will be able to:
- Cite the controls that can be integrated into the period-end closing process, construction of financial statements, and chart of accounts.

Introduction
Closing the books is a complicated process that requires the successful completion of a large number of steps to ensure that the reported results fairly represent the actual financial status of a business – and even then, an outlier event that the accounting staff has never seen before can throw off the reported results. Consequently, it is critical to have a strong system of controls integrated into the closing process to mitigate the risk of issuing incorrect financial statements.

As was the case in many of the preceding chapters, we begin with an overview of the system. However, financial reporting is a complex process where steps are routinely juggled in response to when information is available and whether steps are delayed to deal with a variety of possible problems. Thus, the process flow presented here may vary considerably from what may be experienced in practice. We then move to the controls that can be imposed on the financial reporting process, as well as additional controls that are imposed on public companies, the usual array of ancillary controls, and several supporting policies.

> **Related Podcast Episode:** Episode 78 of the Accounting Best Practices Podcast discusses financial statement controls. It is available at: **accountingtools.com/podcasts** or **iTunes**

For a complete discussion of financial reporting, please refer to the author's *Closing the Books* book.

Financial Reporting Overview
The financial reporting process is not a series of steps to be followed in a particular sequence, but rather a mass of activities, many of which can be handled concurrently, with the output being a set of financial statements. Given the unstructured nature of financial reporting, we present an overview of it in terms of those tasks that can be completed somewhat in advance of the end of the reporting period, and those tasks to be completed immediately following it. Tasks are presented in numerical order, but in fact are likely to be switched around considerably.

Financial Reporting Tasks Prior to Period-End
It is usually possible to make good estimates of a number of reserves and accruals within a few days prior to the end of a reporting period. There is also a closing task related to customer invoices that can be generated in advance. The tasks are:
1. Update reserves for the allowance for doubtful accounts, sales returns, warranties, and so on.
2. Issue recurring customer invoices
3. Accrue expenses for vacations, wages, bonuses, and commissions

Financial Reporting Tasks after Period-End

Many of the following tasks can be completed concurrently, rather in the sequence shown below. However, there are some connections between the various tasks that require a certain amount of sequencing. For example, accounts payable must be closed before the fixed asset register can be finalized, which in turn is needed to calculate depreciation expense. Similarly, accounts payable must be closed in order to finish accumulating overhead, which is then allocated to inventory. Consequently, there is some mandatory sequencing within the following list:

1. Issue final invoices to customers
2. Accrue revenue as needed
3. Count inventory (not needed for a perpetual inventory system)
4. Enter supplier invoices in accounts payable
5. Accrue supplier invoices not yet received
6. Value inventory
7. Allocate overhead to inventory
8. Update the fixed asset register
9. Calculate depreciation
10. Complete the bank reconciliation
11. Close subsidiary accounts
12. Reconcile accounts
13. Review journal entries (preliminary)
14. Consolidate division results
15. Eliminate intercompany transactions
16. Review journal entries (final)
17. Create financial statements (preliminary)
18. Accrue income tax liability
19. Review and adjust financial statements
20. Issue financial statements
21. Close the month
22. Add disclosures

The following flowchart shows the connections, when there are any, between the various financial reporting tasks, with the final stream of closing activities noted across the bottom of the chart. Several activities are excluded from the chart in order to better reveal the overall flow of activities.

The Financial Reporting Process Flow
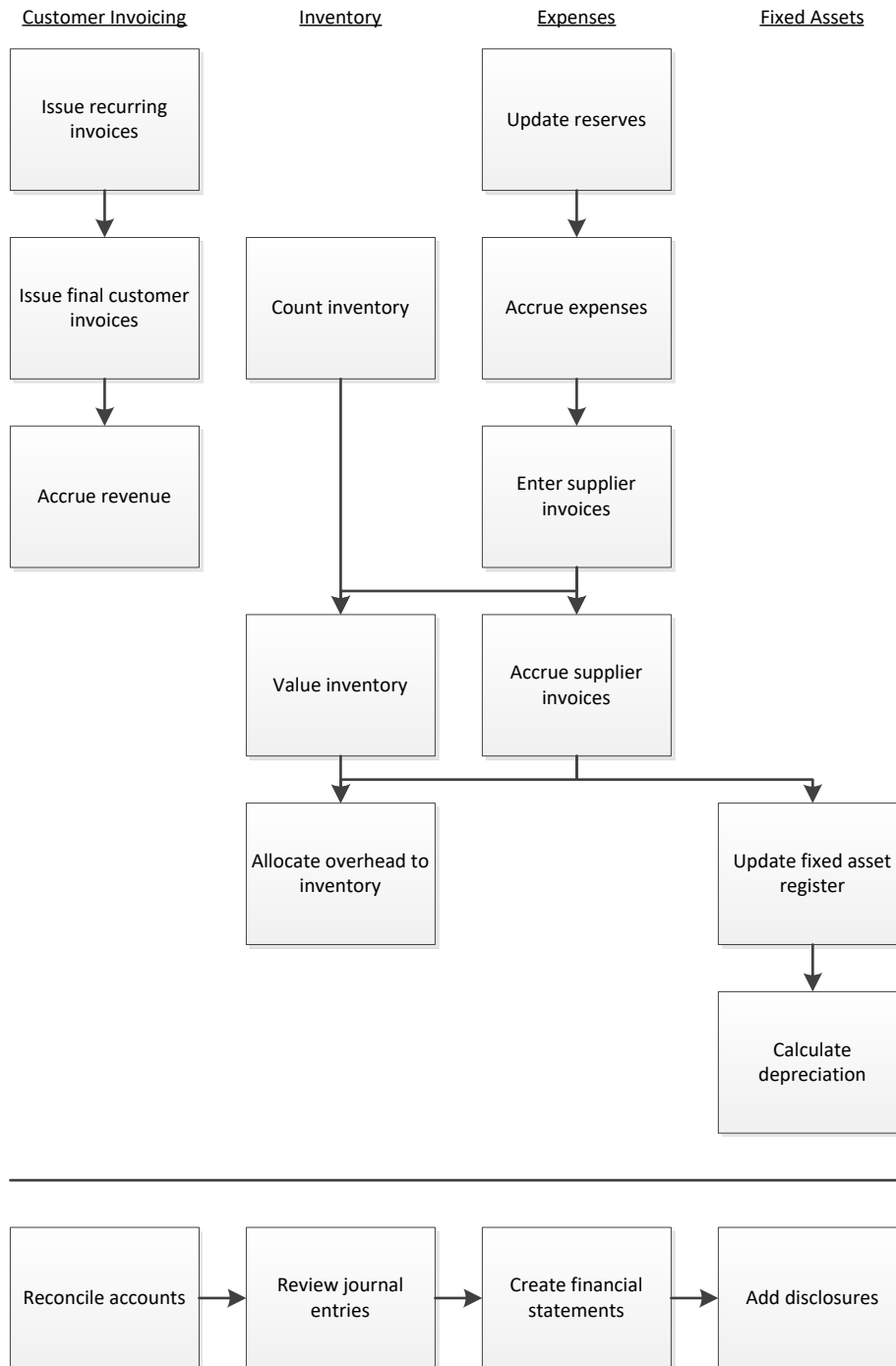
In-Process Financial Reporting Controls

There are a number of financial statement controls to consider using. You can select just one control to address a specific risk, or adopt a larger number of controls that provide multiple ways to mitigate the same risk. We discuss how many controls to implement in the Balance Controls against Speed section. Here are a number of controls to consider:

General Controls

The following controls are designed to introduce some organizational structure to the generation of financial reports, so that financial disclosures are more likely to contain accurate information. The controls are:

- *Use a closing checklist*. The most important control by far is a simple checklist of closing activities, which the controller monitors. This is a good way to verify that all steps required to close the books have been taken.

> **Tip:** When you are first developing the closing checklist, update it immediately after the release of financial statements each month to reflect any improvements to the process that have been uncovered. The sequence of events and contents of the checklist will likely continue to change for at least the first six months.

- *Require supporting documentation*. Anyone involved in the closing process should document the more complex journal entries, and have a second person review them for errors prior to entering them in the general ledger.
- *Assign responsibility*. Assign responsibility for the entire closing process to one person, and assign responsibility for individual activities to those people assigned to the closing team.
- *Limit journal entry authority*. It is more likely that an inexperienced person will incorrectly enter a journal entry in the general ledger, or not enter it at all, or enter it twice. Consequently, password-protect the journal entry screen in the accounting software and limit access to the general ledger accountant.
- *Reconcile accounts*. There should be a mandatory reconciliation of all general ledger accounts that have ending balances larger than a predetermined amount, and which have had activity during the accounting period. This control may include a review of reconciled accounts by a supervisor. If some accounts persistently contain errors, consider requiring a preliminary review of them prior to the month-end close, when the accounting staff has more time for a thorough review.

> **Tip:** It may be possible to conduct preliminary account reconciliations before the end of the reporting period, which reduces the time pressure involved in conducting full reconciliations in the midst of the closing process.

- *Review for residual journal entries*. It is quite possible that a journal entry that was entered in the prior period with the intention of being reversed has not been reversed. This review should be part of the account reconciliations just noted.
- *Controller reviews journal entry log*. The controller reviews the journal entry log with the general ledger accountant to ascertain the nature of all entries made, and signs the log to indicate his or her approval.
- *Review suspense accounts*. Suspense accounts are used to record transactions for which final dispositions are still being worked out. The accounting staff should review the contents of these accounts to see if any can be resolved prior to issuing financial statements.

> **Tip:** The most common inhabitant of the suspense account is the customer payment that cannot yet be applied to a specific account receivable. Since resolving these items merely shifts funds between the suspense account and the accounts receivable account, there is no discernible impact on the balance sheet. Thus, there is no great need to resolve these suspense items prior to the end of the accounting period, at least from the perspective of issuing financial statements.

- *Retain spreadsheets.* If the information used to construct a journal entry was compiled in an electronic spreadsheet, lock down the spreadsheet to prevent it from being cleared out and used again in the next month. By doing so, a historical record is retained for the justifications for journal entries.
- *Organize all closing materials into a binder.* Put all journal entries, bank reconciliations, and supporting reports in a closing binder. This is an excellent tool for researching financial statement issues, though it is not really a control.

Disclosures

If a company is publicly held, it must file an extensive set of disclosures with the Securities and Exchange Commission that must match the contents of the financial statements. This is a key area that demands controls, such as:

- *Match disclosures to financial statements.* A huge problem area is that the information in the disclosures may not match the financial statements. Someone should match the information in every disclosure to the same information in the financial statements, and adjust the disclosures as necessary.
- *Hire an independent reviewer.* If disclosures are to be issued along with the financial statements, consider hiring a third party, such as a CPA firm, to review the disclosures for adequacy.

Cash

The bank reconciliation itself is the central control over cash from the perspective of issuing financial reports, since it not only verifies the cash balance, but also detects additional expenses. The control is:

- *Complete the bank reconciliation.* The main company checking account usually processes a large number of transactions, and so is almost certain to contain a transaction that the company either did not record, or recorded incorrectly. Consequently, it is very useful to either complete a full bank reconciliation before closing the books, or to complete a preliminary one a few days prior to closing the books.

Accounts Receivable

There tend not to be too many errors in the accounts receivable area, though it is helpful to periodically examine any stray journal entries that may be impacting the accounts. The related controls are:

- *Reconcile trade receivables account.* There should be no journal entries impacting the trade accounts receivable account, so review the account for such entries.
- *Reconcile other receivables account.* The other accounts receivable account is the home for many stray receivables, such as for employees and company officers, and is commonly subject to adjustment. If the balance in this account is large, review it every month.

Inventory

Inventory is the single most difficult area in which to obtain accurate results, both in terms of the cost of goods sold and the valuation of any inventory remaining in stock. The following controls cover several of the more problematic parts of inventory accounting – cutoff, counts, and valuation:

- *Verify cutoff.* Verify that the recordation of received goods and shipped goods switched to the following accounting period as of midnight on the last day of the reporting period.
- *Verify inventory quantities*. Ensure that someone audits the inventory quantities in the warehouse on a regular basis, and follows up on errors found. This improves the likelihood that the ending inventory balance and the cost of goods sold are correct.
- *Verify inventory layers*. If an inventory layering system is in place, verify that the costs assigned to the cost of goods sold were properly taken from the correct inventory layers, and that the costs in those layers are correct.

See the Other Controls chapter for expanded treatment of this topic.

Prepaid Expenses

The prepaid expenses account is a prime area for financial reporting errors, for many items linger in the account that should have already been charged to expense. The following control addresses this problem:

- *Monitor the prepaid expenses account.* Verify that all items listed as prepaid expenses were not consumed during the month; if they were, charge them to expense.

> **Tip:** Always charge smaller prepaid expenses directly to expense. This greatly reduces the amount of prepaid asset tracking effort, and has a minimal impact on the results reported in the financial statements.

Fixed Assets

The following two controls are specifically targeted at improving the accuracy of fixed asset record keeping, which impacts the financial statements:

- *Match detail to account balances.* Fixed assets are frequently recorded in the wrong accounts. Therefore, make sure that the asset classification totals in the fixed asset register match the fixed asset account balances in the general ledger.
- *Review sale transactions.* If fixed assets were sold during a period, verify that the transactions were correctly recorded. In particular, verify that the associated amounts of accumulated depreciation were removed from the inventory records, and that gains or losses were properly recorded.

The Fixed Asset Controls chapter contains many other controls, though they have less of an impact on financial reporting.

Accrued Liabilities

The biggest problem with accrued liabilities (such as accrued wages) is ensuring that they are correct. They are typically based on spreadsheet calculations, and the accuracy of the spreadsheets is rarely reviewed. There is also a risk that accruals are not reversed in the following period. Consider installing the following controls to address these problems:

- *Review accrual calculations.* Review the accrual calculations for such items as wages, vacation pay, sick pay, commissions, and royalties, and verify that the general ledger accrual accounts have been properly adjusted for these calculations.
- *Set all accruals to automatically reverse.* The accounting software should contain a feature that allows you to set a journal entry to automatically reverse itself in the following period. *Always* set this flag to reverse accruals. Otherwise, it can be quite difficult to manually track accruals through multiple periods, commonly resulting in misstated financial statements.

Revenue

There are several areas in which revenue can be misrepresented in the financial statements. One problem is that the company may bill more to a customer than the customer's designated funding, which means that the company will likely have to adjust its invoice downward after-the-fact. There may also be problems with missing invoices and incorrectly accrued revenue. The following controls can mitigate these issues:

- *Match invoices to funding.* If a business has contracts with its customers, verify that there are sufficient funds available before issuing invoices. Otherwise, the invoices will be rejected by customers, and the company must subsequently reduce the amount of recorded revenue.

> **Tip:** Maintain a database that offsets the company's invoices against the original amount of customer funding, so that you always know how much funding is available. It may also make sense to periodically confirm this information with customers.

- *Review shipping log*. Compare the sales register to the shipping log to verify that all items shipped to customers have been billed.
- *Approve accrued revenue.* Have the controller review the proposed accrual of revenue.

Income Taxes

It is inaccurate to accrue the incremental income tax rate for any income earned near the beginning of the calendar year, if there is a strong likelihood that the actual tax rate used for the entire year will be higher (as happens with graduated tax rate systems). The following control addresses this issue:

- *Verify income tax percentage.* Verify that the income tax rate used to calculate the income tax liability is the estimated average amount that the company expects to incur during the calendar year.

Additional Controls for Public Companies

Any publicly-held organization is required to bolster its existing suite of financial statement controls with the participation of the following three groups:

- Outside auditors
- Audit committee
- Chief executive officer (CEO)

If a company is publicly held, its auditors are required to review its financial statements for the first, second, and third quarters of its fiscal year. The auditors must complete many audit steps

before they will allow the financial statements to be issued, and those audit steps are essentially a massive cluster of detective controls.

Since the quarterly Form 10-Q cannot be issued without the permission of the auditors, there is no rush to release the financial statements. Thus, there is no tradeoff between the speed of release and the quality of the financial statements; instead, the auditors will work through their review procedures as fast as possible, but are primarily concerned with the quality of the final product.

Despite the presence of the auditors, do not consider them to be a backstop for any failed or missing internal controls. Instead, have a sufficient system of controls already in place for the auditors not to find any problems with the financial statements. A better way to use these reviews is to carefully examine any reports by the auditors of exceptions found, and to then institute new controls to mitigate those issues.

A requirement of being publicly-held is to have an audit committee, which is a sub-group of the board of directors. This group must formally vote in favor of all quarterly and annual financial statements before they are released in the Forms 10-Q and 10-K, respectively. A diligent audit committee may occasionally spot an error or inconsistency in one of these Forms, or they may request clarification of certain statements made within the Forms. Nonetheless, only a few members of an audit committee usually have a strong financial background, so it is unlikely that the committee will spot significant issues. Consequently, the audit committee represents a relatively weak control over the financial statements.

The CEO is required to formally approve any financial statements filed with the Securities and Exchange Commission. It is possible that the CEO may spot problems in the financial statements, but only if he or she has significant financial knowledge of the company (which is not always the case). Thus, this should be considered a weak control.

In short, the participation of additional parties in the production of financial statements provides little additional control in the case of the audit committee and CEO; however the outside auditors may spot a number of issues that the controller can use as the basis for constructing additional controls.

Balancing Controls against Speed

There is a trade-off between installing a formidable array of closing controls and issuing financial statements on a timely basis. In brief, the more controls installed, the longer it takes to issue financial statements. However, the more controls installed, the more accurate the financial statements are likely to be. Thus, the controller needs to evaluate the tradeoff between speed of delivery and the accuracy of the delivered financial statements.

This balance between controls and speed tends to fluctuate over time. A common series of events is for a business to have an established set of procedures in place for issuing financial statements; management decides that it wants to receive them sooner, so the controller peels away the more time-consuming controls and delivers the financial statements within the time frame requested by management. Then an outlier event arises that would have been found if the eliminated controls

were still in place, which leads to some embarrassment within the accounting department, followed by the re-imposition of those controls needed to guard against the outlier event.

In short, it is common to initially abandon some controls in favor of the faster release of financial statements, followed by a modest retrenchment that adds back some controls. The result is an adequate set of controls and the somewhat faster issuance of financial statements.

Additional Financial Reporting Controls – Fraud Related

The key area of fraud risk related to financial reporting is the complete overriding of all controls by the management team – for which it is difficult to formulate an adequate control. However, the following controls may have an effect in situations where management pressure to alter the financial statements is not quite so pervasive:

- *Restrict access to the general ledger*. Only the general ledger accountant should be allowed to make changes in the general ledger. By tightly restricting access, it becomes more difficult for someone to fraudulently make entries to alter the reported results of the company. This control is also useful for preventing confusion regarding who made entries in the general ledger.
- *Issue the financial statements as quickly as possible*. A one-day close can be surprisingly effective at preventing financial statement reporting fraud, since there is no time to add late shipments into the revenue figures for the month, or to ponder other alterations to the reported results.

Additional Financial Reporting Controls – Periodic Actions

The following controls primarily relate to periodic error checking that reduces the risk of issuing incorrect financial reports. They are not necessarily an integral part of the financial reporting process; instead, these are separate tasks. The controls are:

- *Review account reconciliations*. The controller should review and approve all account reconciliations, thereby ensuring that management is aware of all reconciling items in the accounts.

> **Tip:** From a practical perspective, accounts with small ending balances do not require a review by the controller. It should be acceptable to concentrate reviews on those accounts having larger period-end balances.

- *Match default to custom reports*. When a company creates a special version of the financial statements provided with the accounting software package, there is a good chance that some accounts will not be included in the custom reports, or that they will be repeated. You can find these issues by comparing the original default financial statements to the modified versions.

> **Tip:** Whenever accounts are added to or deleted from the chart of accounts, review all custom-made financial reports to see if their results still match those of the default financial statements.

- *Compare financial results on a rolling 12-month trend line*. An excellent way to see if there have been any failings in the closing process is to observe the income statement line items on a month-to-month basis. If there were sudden drops or spikes in different

months (especially in successive months), this is a strong indicator that a revenue or expense item was not recorded in one month, and twice in the next month. This could be a simple search for blips in the trend line of results, or a more quantitatively-precise approach where changes over a specific dollar amount or percentage are investigated. A sample analytical review report is shown next.

Sample Analytical Review

Account	December	November	% Change	$ Change	Issue
Prepaid assets	$80,000	$60,000	33%	$20,000	Deposit on new machinery
Accounts receivable	720,000	480,000	50%	240,000	Christmas sales surge
Inventory	120,000	350,000	66%	-230,000	Draw down for Christmas sales
Debt	400,000	200,000	100%	200,000	Funding for receivables
Revenue	600,000	250,000	1405	350,000	Christmas sales surge
Cost of goods sold	390,000	175,000	123%	215,000	Christmas sales surge
Employee benefits	50,000	25,000	100%	25,000	Christmas bonuses

- *Review auditors' management report*. Many auditors provide a report to management as part of their year-end audit, in which they itemize any control problems found. This can be a good source of issues that the accounting staff might not otherwise be aware of.
- *Account definitions are reviewed annually*. Each account in the financial statements should reliably contain the same types of transactions, period after period. This is not always the case, as the accounting staff sometimes records transactions in alternative accounts, which results in inconsistent presentation of the financial statements. This issue can be mitigated to some extent by reviewing the definitions of the accounts to see if they still apply.

> **Tip:** The preceding control to compare financial results on a rolling basis can unearth unintended changes in the intended use of accounts. You can drill down into these accounts to see what happened, and follow up with the employee(s) who incorrectly recorded transactions in the wrong accounts.

- *Review accounting policies annually*. The controller should review all accounting policies that impact the company's reporting of financial results. It is useful to conduct this review in concert with the company's auditors, who may be able to provide perspective on common industry practice.

> **Tip:** Changing an accounting policy should be a rare event. When it seems necessary to make such a change, the controller should quantify what the impact would have been on the company's financial statements for the past few years, and share this information with the audit committee.

- *Review spreadsheets.* There may be calculation errors in the spreadsheets used to create journal entries, so periodically review the calculations to verify that they are correct.
- *Audit bills of material*. In a standard costing system, the bills of material are used to compile the cost of ending inventory. Adopt an ongoing review system to verify that these bills are correct; otherwise, the ending inventory balance may be incorrect.

Additional Accounting Policies

The following policies can be used to enforce certain aspects of financial reporting relating to the aggregation of and changes to accounting information:

- *The controller must approve all changes to the chart of accounts*. This control is needed to keep tight control over the chart of accounts, which is a particularly important goal when there are multiple subsidiaries, and everyone needs to use the same accounts in order to achieve an easier consolidation.
- *The controller must approve postings to closed periods*. This policy should be tightly enforced to discourage changes to the accounting records for all closed periods.

Summary

The discussion in this chapter makes it clear that a large number of controls could potentially be installed over the production of financial statements. It is quite likely that not all of them are needed, especially if the underlying accounting systems for recording transactions are well-constructed. Consequently, you should continually consider the controls being used, and judge whether adjustments can be made to achieve a system that strips away non-essential controls while still producing reasonably accurate financial reports in a timely manner.

You might consider using a more rigorous set of controls at the end of the fiscal year, so that the annual financial statements are subjected to a considerably more detailed review. This approach might be worthwhile if the year-end financial statements are to be released outside the company. The same logic holds for the quarterly financial statements of publicly-held companies; you could adopt an enhanced set of controls when quarterly reports are to be issued, and scale back the control effort for other months.

Chapter 17 – Review Questions

The review questions accompanying this course are designed to assist you in achieving the course learning objectives. The review section is not graded; do not submit it in place of your qualified assessment. While completing the review questions, it may be helpful to study any unfamiliar terms in the glossary in addition to course content. After completing the review questions, proceed to the review question answers and rationales.

33. A closing task that can be completed prior to the end of an accounting period is:

    a. Issuing final invoices to customers
    b. Counting inventory
    c. Allocating overhead to inventory
    d. Issuing recurring customer invoices

34. The period-end closing for prepaid expenses involves:

    a. Shifting all of them to expense
    b. Charging those items to expense that were consumed in the period
    c. Netting them against accrued liabilities
    d. Apportioning them to subsidiaries

Chapter 18 – Other Controls

Learning Objectives
After completing this section of the course, you will be able to:
- Specify the controls that can be applied to acquisitions, gift cards, inventory recordation, and inventory valuation.

Introduction
Thus far, this book has dealt with controls over specific, major processes, such as order entry, shipping, and payables. These topics have significant procedures and multiple controls, along with complex process flows, so each one has been dealt with in a separate chapter. There are also a number of areas within the accounting department that require fewer processing steps and reduced controls, as well as transactions that occur only at long intervals. In this chapter, we address several of these latter topics, including the accounting for acquisitions, budgeting, gift cards, the recordation and valuation of inventory, and project accounting.

Acquisition Controls
The manner in which the accounting department deals with acquisition transactions can have a profound impact on the decision to complete an acquisition, as well as on subsequent accounting for these transactions. The following controls are intended to direct sufficient resources into due diligence activities, as well as to ensure that these transactions are dealt with in a consistent manner:
- *Use third party diligence teams.* The accounting staff is supposed to be involved in the due diligence effort on acquisition candidates. However, this represents a large time commitment for the accounting staff, and may be required at an inopportune moment when there is little excess staff time available. The result is likely going to be a reduced level of analysis that could result in a purchase recommendation for a business that has hidden flaws. To mitigate this risk, consider employing one or more due diligence teams from outside audit firms to supplement the company's own due diligence personnel.
- *Verify fair values.* When accounting for an acquisition, the amounts at which acquired assets and liabilities are to be recorded should be at their fair values. This is a problem for the accountant, who may attempt to rely upon various internally-derived estimates of fair value. If not fully justified, these estimates may be called into question by the company's auditors. It may be necessary to pay a third-party valuation expert to verify or initially create fair values. The report of this expert can then be used to justify the recorded fair value amounts.
- *Use restructuring expense checklist.* It may be necessary to establish an up-front reserve for restructuring expenses (such as for severance pay and related benefits) related to a newly-acquired entity. If so, the accounting staff should compile the amount of this reserve in a consistent manner from one acquisition to the next. Otherwise, there is a risk of inconsistent recognition of expenses over time. To do so, consider using a standard checklist of possible expenditures that may be required for each acquiree.
- *Review amortization assumptions.* There are typically quite large intangible assets that are recognized as part of an acquisition. If so, these assets must be amortized; this calls for the derivation of periods over which they are to be amortized. The controller should review the amortization assumptions associated with each of these assets, and should

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consider also discussing them with the company's auditors. Ideally, the periods used should be consistently applied for various types of intangible assets.

- *Formalize goodwill impairment analysis*. Any goodwill asset is to be reviewed for possible impairment at least once a year, if not more frequently. To ensure that this analysis is conducted, include impairment testing on the department's list of activities, and also lay out the impairment methodology in a formal procedure. Also, state in the procedure the circumstances under which impairment analyses should be accelerated. This level of formalization ensures that impairment is dealt with in a consistent manner over time.

Budgeting Controls

Control systems are usually intended for business transactions that occur on a regular basis, and which involve the transfer of assets. Budgeting does not initially appear to require controls, since it is only an annual event, and it is not directly associated with accounting transactions. However, confusion can arise because of the multiple versions of a budget that are typically scattered throughout a company. Also, the budget is not directly integrated into a company's operations, and so tends to be forgotten. In this section, we describe several controls that address these problems.

Related Podcast Episode: Episode 76 of the Accounting Best Practices Podcast discusses budgeting controls. It is available at: **accountingtools.com/podcasts** or **iTunes**

Budget Creation Controls

A serious problem with any budget is that the normal iterative approach to creating it results in having a number of versions littering the company. The following controls are intended to lock down the final version and ensure that everyone in the company is using it:

- *Approve the budget*. There may be situations where managers claim that they did not approve of some aspects of the budget. To avoid this issue, have the board of directors formally approve a specific version of the budget, and include that version in the board minutes. This tends to quell dissent.
- *Label the final budget*. There will likely be several iterations of a budget, which means that some managers may end up using the wrong version. To avoid this problem, put the words FINAL BUDGET or APPROVED FINAL BUDGET in the footer of every page in the budget. Also state in the footer the date of the budget. Further, print and bind the final version and hand it out to all approved recipients. To be absolutely certain that managers have received this final version, have them sign a receipt when you hand out the final version, and retain the receipts. By taking these steps, it is nearly impossible for a manager to be working from the wrong version of the budget.
- *Match loaded version to approved version*. Once the budget has been approved, load it into the accounting software, in order to generate financial statements in an actual versus budget format. Given the volume of budget information to be entered, it is quite likely that some of the budget information will be entered into the accounting software incorrectly. Consequently, match the loaded version of the budget to the approved version, and adjust the loaded version for any errors found.
- *Password-protect the loaded budget*. Though unusual, it is possible that an employee could access the accounting system and alter the budget loaded into the accounting

system, presumably making their budget versus actual reports look more favorable. This risk can be mitigated by password protecting the accounting software, only giving access permission to certain employees, and by using a change log to track who has made changes to the budget. Also, when financial statements are issued at the end of each reporting period, consider verifying the budget totals in the statements as part of the standard closing procedure.

- *Password-protect the budget file.* It is quite easy for someone to access the completed budget file and inadvertently make changes to it. To avoid this issue, impose password protection on the file. In addition, archive the file, preferably in an off-site location. Further, consider printing and binding a copy of the budget, and storing it in the corporate archives.
- *Create procedure for changing accounts.* It will sometimes be necessary to delete accounts from or add accounts to the chart of accounts. When you do this, it may be necessary to alter the amounts of any budgets linked to those accounts. For example, when an account is deleted, shift the associated budget to some other account; otherwise, the budget totals in the accounting system will no longer match the official budget. Also, if an account is added, it is possible that a portion of the budget charged to another account should be allocated to the new account. To make sure that this is done, create a formal procedure for account changes that includes the revision of associated budget amounts, and require a review every time such changes are made.

Of the preceding controls, the one most likely to mitigate problems is matching the loaded version of the budget to the approved version. If there are many budget line items to be transferred from the approved budget to the accounting software, it is extremely likely that at least a few budget items will be transferred incorrectly. Consequently, matching the loaded version to the approved version is critical.

Budget Integration Controls
An unfortunate reality of budgeting is that, once completed, many budgets are placed in a drawer and ignored until it is time to create a new one in the following year. Consider using the following controls to ensure that the budget is so thoroughly integrated into corporate operations that it cannot be ignored:

- *Include in purchasing system.* If the purchasing department uses a computerized purchase order system, enter the budgeted expense amount into the system for each expense line item. Then, as the purchasing staff enters purchase orders into the system during the budget period, the system accumulates the amount of expense and compares it to the budget; if the accumulated amount exceeds the budget, the system rejects any further purchase orders. For example, if there have already been $48,000 of accumulated purchase orders for office supplies during the budget period, the creation of another purchase order that moves the total past the annual budget of $50,000 will either be rejected outright or cause a warning flag to be generated. This can be an onerous control, especially in the last few months of a budget year, when numerous expense line items are approaching their allowable maximum expenditure levels.

  A simpler alternative is to issue a budget versus actual report to managers at regular intervals that warns them of impending overruns in their budgeted amounts. Better yet,

generate the report only on an exception basis, so that employees only see those expense line items for which there are few funds remaining.

This control does not work well if block budgeting is used, where funds are allocated to a cluster of expenses, and can be shifted among those expenses at the discretion of the responsible employee.

- *Include in performance appraisals.* If the human resources department manages a periodic employee performance appraisal process, then ensure that they include in these appraisals a comparison of budgeted to actual expenditures for any expenses for which an employee is responsible. These appraisals should be tied to employee promotions and pay rate changes, in order to fully gain their attention. For example, holding expenses below the budgeted amount may earn a department manager a bonus, while exceeding the annual sales quota may trigger the payment of a larger commission to a salesperson.
- *Include in financial statements.* By far the most common budget integration control is to include the budget in the financial statements. The information appears in a separate budget column next to actual results, and may also be presented in a format where the dollar variance and percentage variance between the two figures is stated. This approach presents budget information to management on a continuing basis, but does not force anyone to use the information.
- *Include in responsibility reporting system.* Create a set of reports that are distributed to all employees who are responsible for any parts of the budget, in which are shown budgeted versus actual expenditures or revenues. Any employee receiving these reports should only see the budget line items for which they are specifically responsible. Thus, the engineering manager will receive a report pertaining to the performance of the engineering department, while a salesperson only receives a report for the sales generated by his sales region. This reporting system may result in dozens of separate reports, but is so closely tailored to individual responsibility levels that it is hard to ignore – especially if the company president includes handwritten notes on each of the reports! It should be possible to have the accounting system automatically generate these reports at the end of each accounting period.

The controls outlined here assume that management wants to use the budget as a control device. If they intend to instead use it as an occasional planning tool, it is not necessary to adopt these controls.

Summary of Budget Controls

When designing controls for a budgeting process, a key issue to remember is that, depending upon the intentions of management, the budget may be considered an authorization to commit funds. As such, be certain that it has been properly approved, that the correct version is in use, and that there is a proper feedback loop in place to ensure that the organization is aware of it. The system of controls adopted should meet these goals. In the absence of controls, there is a significant risk that a company will commit the incorrect amount of funds to various activities, resulting in inadequate financial performance. Thus, budgetary controls can have a significant impact on the overall performance of a company.

Gift Card Controls

A company may hand out gift cards (essentially pre-loaded debit cards) to its employees to celebrate the holidays, or as rewards for work well done. These cards are typically purchased in quantity and held within the accounting department until requested by a manager who wants to reward an employee. Since these cards are readily convertible into cash and goods, they are at a high risk of theft or misuse. The following controls can be used to mitigate this risk:

- *Lock up cards*. All unused gift cards should be locked up in the office safe, or within a locked petty cash box.
- *Reduce the number purchased*. Only purchase a sufficient number of gift cards to meet the company's needs for a relatively short period of time, or for a specific event. This reduces the number of cards on hand that can be stolen.
- *Require a recipients list*. If a manager requests a gift card, require that they submit the name of the recipient. This presents a burden of proof that can be held over the manager, if the accounting staff ever decides to follow up with the intended recipients (see the next point).
- *Email intended recipients*. It is possible that a manager will request a gift card for an employee and then keep the card. To mitigate this risk, have the human resources department issue all gift cards, as well as email the intended recipients with a congratulatory message. If they never received a card, they will be sure to respond.
- *Sign for received cards*. If a gift card is for a significant amount, have the recipient sign for the card, so there is proof that the funds have been transferred to the employee. The signed receipt can be retained for a reasonable period of time, in case the distribution is called into question at a later date.

These controls may seem oppressive, and probably are if a company only issues a small number of low-cost gift cards per year. However, if gift cards are a major form of employee recognition, the amount of cash involved may make these control suggestions more palatable.

Information Technology Controls

There is an extensive body of work regarding the controls for information technology, which go well beyond the accounting focus of this book. However, an accounting manager may be responsible for an accounting software package, and so should be aware of the controls pertaining to that specific system. The following controls may be applied:

- *Back up files*. To keep from losing information, have a procedure for backing up files on a daily basis. There should be multiple backups, so that damage to one backup will not result in the complete obliteration of valuable information. In addition, some of these backups should be stored in a secure off-site location, to mitigate the risk of damage or theft. It may be possible to engage the services of an automated backup service, which automatically backs up files to an off-site location on an ongoing basis. If a software-as-a-service accounting package is used, the underlying data is already being backed up off-site by the service provider.
- *Control user access*. Set up system security so that users of the accounting system are only given password access to those software modules for which they have responsibility. Thus, a billing clerk has access to the billing module, but cannot access the general ledger or payroll modules. Also, consider locking out users who have three consecutive failed login attempts, to prevent unauthorized access. Further, have a system in place for

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immediately cancelling access to the system when an accounting person leaves the employment of the company. There should also be a firewall and intrusion detection systems that will block or detect access by unauthorized parties.

- *Implement input controls*. Any data validation features in the accounting software should be turned on, so that data is automatically reviewed by the system as it is being input, and is rejected if the data falls outside of predetermined parameters. For example, an entered product quantity in a customer invoice can be rejected if it exceeds a predetermined upper limit. Or, a payroll entry is rejected if the overtime hours worked by an employee in a week exceeds a maximum upper limit.

- *Maintain physical security*. Maintain an adequate level of security over the server on which the accounting software and data files are stored. This can include a fire protection system that does not use water, which would otherwise ruin the hardware. Other options are an on-site backup power supply (at least a battery backup so that the system can be shut down in an orderly manner in the event of a power failure), a separate air conditioning system, and security card access to the storage area. It can also make sense to locate facilities on high ground or on the upper floors of a building to minimize the risk of flood damage.

- *Operate change log*. If the software has a change log feature, ensure that it is turned on and that access to the log is highly restricted. Change logs are useful for determining which user has entered data or made other changes to the system.

- *Properly dispose of data*. The accounting system contains all kinds of sensitive data, such as employee social security numbers and customer credit card information. Any documents containing such information should be shredded when it is disposed of, while electronic storage media being disposed of should be dealt with in a similar manner.

- *Review report changes prior to release*. When a change is made to a report, compare its results to what was issued under the preceding report structure to see if there are any differences. Also, consider conducting a manual compilation of the underlying data to see if the report results can be duplicated. Finally, review the report for anomalies. Only authorize the report for release after these steps have been taken.

- *Update software regularly*. Update any software package updates as soon as they are released. These updates may contain bug fixes that prevent hackers from accessing the system, as well as any number of control and functionality improvements.

If a firm has substantial on-site accounting systems, it can make sense to develop a disaster recovery plan. These plans are designed to restart operations if the primary information technology location is destroyed or damaged (perhaps due to flooding or a fire), and may call for the operation of a backup facility, with procedures in place to shift data and employees over to that location. The most effective disaster recovery plans are ones that are updated regularly, with scheduled practice conversions to the backup site.

Inventory Recordation Controls

The accounting department is not directly responsible for the accuracy of the inventory records. However, since inventory may comprise a large part of the assets reported in the balance sheet, it is vital to have controls in place that the accounting staff can employ to gain some confidence in the accuracy of the inventory records. Consider the following possibilities:

- *Audit physical inventory counts*. The warehouse manager is responsible for conducting physical inventory counts at regular intervals. However, there is no guarantee that the resulting inventory counts will be accurate, so the accounting staff can participate in these counts in an audit role, reviewing the activities of the count teams and the results of their counts.
- *Audit cycle counts*. If a company is using a perpetual inventory system to update its inventory records, the warehouse staff likely engages in ongoing cycle counts, where they count small samples of the inventory on a daily basis and investigate any variances found. The accounting staff can review these counting activities, as well as conduct sample counts of the inventory, to determine how much reliance it can place on the accuracy of the resulting inventory records.
- *Review checklist of off-site storage locations*. When a business stores inventory at off-site locations, these items are commonly not tracked in the main inventory database. If so, there is a risk that the off-site unit quantities will not be updated on a regular basis. To avoid the risk of incorrect quantities, maintain an updated list of all inventory locations, and ensure that updated quantity reports are received from these locations as part of the closing process.
- *Audit off-site locations*. When inventory is stored in off-site locations, do not assume that the information reported by these locations is correct. There may be errors in unit counts, units of measure, and item descriptions. A periodic audit of each location will detect these issues.

Inventory Valuation Controls

The accounting department is directly responsible for creating a proper valuation of the ending inventory. Since this can result in quite a large asset, there should be a correspondingly large number of controls clustered around the valuation function. Consider the following control options:

- *Audit cost layers*. If the costing system involves the use of cost layers, periodically audit the cost layer records, tracing inventory costs back to specific supplier invoices. This control is less necessary for earlier cost layers that are rarely accessed, and more necessary when cost layers are manually maintained. In cases where cost layers are manually maintained, also trace supplier invoices forward into the cost layers, to ensure that costs are being properly recorded.
- *Match standard costs to actual*. When a standard costing system is used, the difference between actual and standard costs should be relatively small. To ensure that this is the case, require that a formal review of all standard costs be conducted at least annually. Also, if there are notable differences between standard and actual costs, verify that these differences are being charged to the cost of goods sold as a variance within the correct reporting period.
- *Restrict access to bill of material records*. Many organizations compile the value of their finished goods inventory from bills of material, which identify the exact components included in each product. If someone were to illicitly access and alter these records, the result could be a drastic change in the recorded value of inventory. The same result could arise from an inadvertent updating error. To prevent these changes, require password access to the bill of material records in the computer system, and only grant access to a

few employees. Also, change the password regularly to prevent it from becoming common knowledge.

- *Audit bill of material records*. Since bills of material are used to derive the value of finished goods, it behooves the accountant to insist that these records be audited for accuracy. Ideally, someone other than the bill of material originator should compare the actual components used to construct a product to the components listed in the bill of materials. These records should be re-examined whenever there is an engineering change order, to ensure that they still reflect the actual status of a product.

- *Review journal entries*. A large number of journal entries may record transactions in the cost of goods sold and/or inventory accounts. Each of these entries represents a possibly incorrect entry that could seriously impact the inventory valuation. To ensure that these entries are reasonable, require a separate review and sign-off on each one. Also mandate that each entry must be accompanied by a document that justifies the reason for the entry, including supporting calculations.

- *Audit production setup calculations.* When there is a substantial production setup cost associated with a production run, this cost may be allocated to each unit in the production run. If the number of units actually produced varies from the amount assumed in the allocation calculation, the result can be a substantially incorrect inventory cost. For example, a setup charge of $1,000 is only $1 per unit if 1,000 units are produced, but is $100 per unit if just ten units are produced. Given this potential for enormous cost disparities, be sure to audit production setup calculations. This is of particular importance in a standard costing system where a standard setup charge may be loaded into bills of material without any consideration of the actual number of units produced in subsequent production runs.

- *Conduct obsolete inventory review.* There should be a regular examination of the inventory by a qualified group that is focused on rooting out and disposing of those inventory items that are obsolete. Otherwise, the inventory valuation will be inflated by the values of items that cannot be sold off at a reasonable price. Someone from the accounting staff should be assigned to this committee, to verify that obsolescence reviews are adequate and being conducted at regular intervals.

- *Create allocation procedure.* The process of allocating overhead costs to inventory and the cost of goods sold is a manual one, and therefore subject to error. To mitigate the probability of errors, create an allocation procedure that precisely defines which costs are to be included in cost pools and how these cost pools are to be allocated.

- *Audit allocation calculations.* Conduct a periodic review of the overhead allocation calculations. The intent is to ensure that the correct costs are being included in cost pools, and that these pools are being appropriately allocated to ending inventory and the cost of goods sold based on the allowed allocation procedure.

- *Review overhead trends.* Create a report that shows the aggregated amount of overhead stored in the company's designated overhead cost pools at the end of each reporting period and prior to their allocation to cost objects. When this report is presented in a trend line format for the last 12 months, any unusual spikes or declines will be immediately apparent. Further investigation of these anomalies may reveal unauthorized changes in the costs included in the cost pools.

- *Review product cost trends.* There are many ways in which the recognized cost of a product can be incorrectly compiled. To detect these issues, create and review a report

that tracks the calculated cost of each inventory item on a rolling 12-month trend line. Better yet, set the report to reveal percentage changes in costs on the same trend line. A brief examination of this report will reveal unusual cost spikes or declines, which can be used as the basis for additional investigative work.

- *Review extended costs.* At the end of a reporting period, create a report that multiplies ending unit quantities by their costs to arrive at extended costs, and sort the report in declining order by extended cost. The first page of this report will reveal those inventory items that comprise the bulk of the inventory valuation. It is worthwhile to review this page to see if any inventory valuations look out of place. For example, an inadvertent change in a unit of measure could skyrocket the valuation of a lowly inventory item into the upper echelons of the inventory valuation.

A substantial number of controls can potentially be involved in the inventory valuation area. You can select which controls to use based on an analysis of the types of costs involved (such as a preponderance of direct costs or overhead costs), as well as the history of errors that have occurred in the past, and an analysis of which errors might result in large valuation errors.

Project Controls

The accumulation of costs for a project and subsequent billings to customers can yield unexpected results in a surprising number of ways – either due to fraud, mismanagement, or minimal formal processes. The financial and reputational impact of incorrect project costing and billing can be substantial. To mitigate these impacts, we describe in this section a number of project controls aggregated by certain contract types, as well as for internal projects.

Controls for Cost Plus Pricing Arrangements

Project controls are especially necessary when a company is billing to a customer under a cost plus pricing arrangement. In this situation, there is a strong temptation to add unauthorized costs to a project in order to bill these costs through to the customer, along with a profit percentage. The following controls can be used to mitigate this risk:

- *Establish cost definitions.* Work with the customer to develop a definition of each type of cost that is to be allowed within a project. This should include the contents of all overhead cost pools. A cost pool is a grouping of individual overhead costs, which are then allocated. Having cost definitions makes it easier to determine whether a cost should be included in or excluded from a project.

> **Tip:** Continue to refine cost definitions over time, as various costs are encountered for which the existing definitions are not sufficiently clear. By doing so, it will become easier to include costs in or exclude them from projects, which in turn leads to fewer conflicts with customers.

- *Establish allocation methodologies.* There may be a temptation to increase the allocation of overhead to a specific project, so that the allocated cost can be billed to a customer. However, doing so will likely result in an irate customer. Consequently, document at the start of a project the allocation calculations that will be used. The internal audit staff can then verify that the established allocation is being used throughout a project.

- *Establish expense approval process*. Have a member of management above the level of the project manager approve the larger expenses before they are incurred. Doing so reduces the risk of incurring inappropriate expenses.
- *Review appropriateness of expenses*. It is possible that excessive or improper costs will be charged to a project. These can be difficult to detect, especially when the amounts charged are relatively small. Nonetheless, there should be a routine internal audit examination of project costs that delves into the applicability of charged expenses. When non-compliant expenses are found in a project, the audit team should not only document these issues, but also trace them back to the person who authorized the original recordation. This may lead to further investigations into other costs authorized by the individual, to see if there is a pattern of over-charging projects.

Controls for Fixed Fee Pricing Arrangements

When a company engages in fixed fee pricing arrangements, there is a certain amount of pressure for project managers to report a profit by the end of a contract. If so, a manager might be tempted to offload expenses elsewhere, rather than charging them to a project that is in danger of having a minimal profit or even a loss. The following controls can be used to mitigate this risk:

- *Use cost checklist*. When first devising a bid for a fixed fee pricing arrangement, use a standard checklist of costs that should be included in the formulation of the bid. It is entirely too easy to forget a major cost, which in turn is difficult for a reviewer to spot, since it is absent from the bidding documentation. Thus, a cost checklist that is based on costs incurred in previous projects is an excellent way to reduce the risk of underbidding.
- *Review percentage of completion*. When a fixed fee arrangement spans a number of months, the seller may be able to recognize some portion of the total revenue prior to final project completion. The estimation of the amount of revenue to recognize is subject to fraud, since the information used for this determination can be altered, and is subject to interpretation. To mitigate this risk, periodically have a third party review the calculation of the percentage of completion. Better yet, develop a documented methodology for calculating the percentage of completion, and review the ability of managers to follow this process.
- *Conduct milestone reviews*. It is entirely possible under a fixed fee arrangement that the seller will incur more costs than it can recover from the pricing structure of the underlying contract. If so, the amount of costs already incurred that will not be recovered must be charged to expense at once. To aid in making this decision promptly, build into the project timeline a series of milestone reviews. These reviews should examine the costs incurred to date and the projected costs required to complete the project, and make a determination of whether any costs should be written off.
- *Monitor scope changes*. One of the chief causes of losses in a fixed fee arrangement is when the customer demands changes in the scope of the project, and the project manager does not respond with a change order to raise the price. Instead, the cost of the project spirals upward with no attendant increase in billings to the customer. The best control over scope changes is proper training of the project manager in regard to the nature of scope changes and how to press for a change order. An additional control is to conduct periodic audits of open projects to see if scope creep has occurred without an attendant approval by the customer of a change order.

- *Close completed projects promptly*. Once a project has been completed, close it at once, so that no additional transactions can be charged to it. Otherwise, a canny project manager could charge a cost to it that should belong elsewhere. The charge may not be noticed, since all reporting related to the closed project has already been completed.
- *Conduct closing review*. Once a project has been completed, conduct a formal written review of the project that states the revenues billed and expenses incurred. The project manager should sign off on this document, which is then securely archived. The reason for this review is to establish a record of the amount of approved costs incurred. If the project accounting records later reveal a different cost total, this indicates that the records were subsequently manipulated.
- *Monitor change log*. If project costs are being recorded in a formal accounting database, the accounting system may contain a change log. This is a listing of the user identification numbers of anyone altering the accounting information, including the records changed and the nature of the changes. Turn on this change log, and include in the department's schedule of activities a monthly reminder to examine the log for unusual changes. This task could identify the unapproved shifting of costs between projects.

Controls for Internal Projects

When an organization is engaged in a construction project for its own internal use, there may be a temptation to park costs in an amorphous construction-in-progress account, rather than charging them to expense in the current period. Doing so defers expense recognition. In addition, there is a tendency for internal projects to have cost overruns, usually because the expectations for these projects were poorly defined. The following controls deal with these and other concerns:

- *Assign a project sponsor*. If there is a person in management who is directly responsible for a project, that individual will be quite likely to spend time overseeing its progress. If there is no such individual, a project is much more likely to drag on and accumulate costs.
- *Create a project budget*. There should be a carefully-defined budget for each project. In addition, the project accountant should periodically compare actual costs incurred to this budget, and report material variances to senior management.
- *Lock the project budget*. When a project manager is judged based on a comparison of actual to budgeted results, there is a temptation to increase the size of the budget. Doing so shrinks any negative variances due to cost overruns. This can be avoided by password-protecting access to the original budget file.
- *Enact a monitoring plan*. There should be a formal system in place that requires managers to examine the progress to date on a project, as well as the costs incurred. Progress can be measured in a number of ways, including:
  - Hours worked to date
  - Costs incurred to date
  - Remaining hours required to complete the project
  - Remaining costs to be incurred to complete the project
  - Milestone tasks completed

  Someone with the power to shut down a project should participate in this examination. Otherwise, there is a tendency for the existing project staff to perpetuate a project, since it gives them ongoing employment. It can also be useful to issue status reports in between

these formal meetings; adverse information in a status report could trigger an additional review meeting to see if corrective action should be taken.

- *Document project decisions*. If decisions are made during a project to cut back on or increase funding, document the reasons why these decisions were made. This documentation should include an approval signature from the assigned project sponsor or project manager. This control assigns responsibility for actions taken.
- *Conduct impairment reviews*. If there is a risk that the outcome of a construction project will be a failure, conduct regular reviews of the status of the project. If it appears that the project will fail, or that there will be large cost overruns, create an impairment charge in the current period. The amount of this charge could correspond to the entire amount invested in the project to date, if there is no expectation that a usable asset will be created. The amount of the impairment could also be a lesser amount, perhaps reflecting the amount of any cost overruns.
- *Define the expected outcome*. Define the characteristics of what is considered to be a successful outcome of the project. By being as specific as possible, one can then define when such an outcome has been reached, so that a project can be terminated. Otherwise, there is a tendency for it to drag on, accumulating costs.
- *Conduct a post-project review*. Once a project has been completed, compare the original time and cost estimates to the amounts actually incurred. Despite being after-the-fact, this can be considered a control, since a poor project review could impede the career of the sponsoring manager, whose poor estimating abilities or management skills led to an inadequate outcome. Thus, knowing that a post-project review will be conducted could lead a manager to be especially careful in estimating for and managing a project.

Summary of Project Controls

The level of control over project costs related to customer billings should be quite high. The reason is that an overbilling found by a customer's audit team may trigger a penalty clause that requires the company to not only pay back the amount of the overbilling, but also pay an additional penalty. In addition, egregious overbillings may lead to a company being removed from the approved supplier lists of its customers.

Another way of looking at project controls from a customer's perspective is when the seller's internal audit staff decides that a customer was overbilled, and voluntarily issues a payment back to the customer in the amount of the overbilling. This is such an unexpected outcome from the perspective of the customer that the seller may become a preferred supplier to that customer for future projects.

Chapter 18 – Review Questions

The review questions accompanying this course are designed to assist you in achieving the course learning objectives. The review section is not graded; do not submit it in place of your qualified assessment. While completing the review questions, it may be helpful to study any unfamiliar terms in the glossary in addition to course content. After completing the review questions, proceed to the review question answers and rationales.

35. A possible control over the verification of acquired asset fair values is to:

    a. Keep all fair value compilation work in-house
    b. Ensure that due diligence teams examine all assets
    c. Employ a third-party valuation expert
    d. Use a checklist

36. The reason for auditing bill of material records is to:

    a. Ensure that they are accurate
    b. Verify the amounts of overhead allocated from cost pools
    c. Ensure that obsolete inventory is identified as such
    d. Ensure that cost layers are properly recorded

Review Question Answers and Rationales

Review question answer choices are accompanied by unique, logical reasoning (rationales) as to why an answer is correct or incorrect. Evaluative feedback to incorrect responses and reinforcement feedback to correct responses are both provided.

Chapter 1

1.   An event that can trigger a review of the system of controls is:

   a. Engaging in the annual strategic planning process. Incorrect. Strategic planning is only concerned with the general competitive posture of a company, and so does not include a controls review.
   b. Hiring a general ledger accountant. Incorrect. Hiring a general ledger accountant may upgrade the content of the general ledger accounts, but has no direct impact on controls.
   c. Going public. Correct. Going public typically includes an upgrade to the system of controls, since publicly-held firms are expected to have robust control systems.
   d. Engaging in the annual budgeting process. Incorrect. Engaging in the annual budgeting process does not include a controls review, since the budget is only concerned with the projected future results and financial position of a business.

2.   The _____ area should have some of the most comprehensive controls in a company.

   a. Recordkeeping. Correct. Recordkeeping requires excellent controls, since a company needs high-quality financial statements, and these documents are derived from the recordkeeping system.
   b. Product development. Incorrect. An error in the product development area does not have a drastic effect on the quality of financial information reported, though it can impact the quality of goods released to the market.
   c. Sales and marketing. Incorrect. A moderate level of control is needed in the sales and marketing area in order to monitor expenditure levels.
   d. Maintenance. Incorrect. Though recordkeeping for machinery maintenance is important, maintenance does not require a comprehensive system of controls.

Chapter 2

3.   It may be necessary to request a replacement purchase order from a customer when:

    a. The company backorders some items. Incorrect. A backorder does not require a replacement purchase order. The company simply ships the backordered items as they become available.

    b. There is a significant difference in the terms used on the purchase order from those used by the company. Correct. A significant difference in terms between the company and customer should call for a replacement purchase order that clearly specifies which terms will prevail.

    c. The company cannot deliver on time. Incorrect. The customer may cancel or accept an order if it is late, but will rarely replace a purchase order for this reason.

    d. Its credit card payment is rejected. Incorrect. The method of payment has nothing to do with a purchase order. Payment comes much later in the procurement process.

4.   An example of a validation check is to:

    a. Verify the authority of the person placing the order. Incorrect. Examining the authorization of the person placing an order is not a validation check. If this were a validation check, the system might examine the name of the authorizing person for the correct spelling.

    b. Automatically check quantities on hand. Correct. Automatically checking the quantity on hand is a validation check, since it is an examination of the information being input into the system.

    c. Send a copy of the sales order to the credit department. Incorrect. A credit review is not a validation check, since it does not verify that information is correct.

    d. Separate order taking from cash receipts. Incorrect. Separation of duties is not a validation check, since there is no verification that information is correct.

Chapter 3

5.   The granting of credit to a new customer is typically based on:

    a. A credit application. Correct. A credit application is typically the primary basis upon which credit is granted, since it contains financial information about a business, as well as credit and bank references.

    b. Whether goods are in stock. Incorrect. The granting of credit should not be based on whether goods are in stock, since this does not account for the ability of a customer to pay.

    c. Automatic waivers by the computer system. Incorrect. A credit waiver may be granted for small orders, but does not apply to larger ones. Doing so would put a company at excessive risk of credit losses.

    d. The amount of unused credit. Incorrect. Only an existing customer has unused credit. Therefore, this option is not available to a new customer.

6.   A good way to ensure a credit review is:

    a. Not allowing an invoice to be issued without a credit stamp. Incorrect. By the time an invoice is to be issued, the goods would already have shipped, so this is a bad time to be requiring a credit stamp.

    b. Not allowing shipment without a completed pick list attached to the sales order. Incorrect. Attaching a completed pick list to a sales order only ensures that a complete order was shipped; it does not ensure a credit review.

    c. Not allowing shipments without a credit stamp on the pick list. Incorrect. A credit stamp on a pick list would keep items from being picked for shipment, but would not work in a drop shipping situation where a supplier ships the goods on behalf of the company.

    d. Not allowing shipments without a credit stamp on the sales order. Correct. Not allowing shipments without a credit stamp on the sales order is a good way to ensure that orders are routed to the credit department for a review. Otherwise, orders could be fraudulently shipped without any examination by the credit department.

Chapter 4

7.   If an item is not in stock, a copy of the backorder form goes to the:

    a. Accounts payable staff. Incorrect. The accounts payable staff only needs to know what to pay, not what has not yet shipped to customers.

    b. Billing clerk. Incorrect. The billing clerk only needs to know what has already shipped, for billing purposes

    c. Order entry staff. Correct. The order entry staff may contact the customer regarding items on backorder, and so needs a copy of the backorder form.

    d. Sales manager. Incorrect. The sales manager is not usually notified of individual backorders, unless it is so significant that it could impact a customer relationship.

8.   The shipping log is useful to the accounting department:

    a. To relieve shipped inventory from the inventory records. Incorrect. Inventory records are not altered based on the shipping log. The log is more of an outcome of the shipping process.

    b. To verify that all shipped items were billed. Correct. The shipping log can be used to verify that all shipped items were billed. The log is more commonly used to document all shipments made and the common carriers used for those shipments.

    c. To process payroll for the shipping department. Incorrect. The shipping log is not used to process payroll, since it does not contain wage information.

    d. To prove nexus for sales tax purposes. Incorrect. Verification of nexus is usually proven with the invoice register or invoice copies, not the shipping log.

Chapter 5

9.   Billing to the customer is triggered by:

   a.   Receipt of the initial order. Incorrect. Billing is not triggered by receipt of the initial order, since no goods have been issued or services provided yet.
   b.   Granting of credit by the credit department. Incorrect. Billing is not triggered by the granting of credit, since no delivery has yet been made.
   c.   Picking of goods from stock. Incorrect. Billing is not triggered by the picking of goods, since they have not yet been shipped to the customer.
   d.   Shipment of the order. Correct. Billing is triggered by shipment of the order to the customer. Billing on any earlier date would constitute excessively early revenue recognition.

10.   A reasonable control over website entry of a customer invoice is:

   a.   To call and inquire if it was entered properly. Incorrect. Calling the customer to verify an orders would be an archaic and time-consuming control.
   b.   To proofread the entry before pressing "enter". Incorrect. Proofreading an entry does not prove that the website accepted the entry
   c.   To obtain a confirmation from the website. Correct. A reasonable control for the entry of an invoice into a customer website is to obtain a confirmation, to ensure that the invoice was received.
   d.   To obtain a user ID from the website. Incorrect. Obtaining a user ID does not give any control over the entry of a customer invoice.

Chapter 6

11.   The allowance for doubtful accounts is commonly calculated:

   a.   Under cash basis accounting. Incorrect. The allowance is commonly calculated under the accrual basis of accounting, since it results in an accrued expense.
   b.   Based on billings that have not yet been issued. Incorrect. The allowance is commonly calculated based on billings that have already been issued, which provides a historical comparison of prior billings to bad debts incurred.
   c.   Solely at the end of the calendar year. Incorrect. The allowance is calculated throughout the year, so that a reasonable allowance is always being reported.
   d.   By applying a bad debt percentage to each 30-day bucket. Correct. The allowance is commonly calculated by applying a bad debt percentage to each 30-day bucket in the aged accounts receivable report.

12.   A reasonable control over the collections staff is:

    a. Restriction of credit levels granted. Incorrect. Restricting credit only reduces the amount of sales on credit; it does not enforce any control over the collections staff.
    b. **Supervisory approval of actions taken. Correct. Supervisory approval of actions taken is a control over the collections staff. Doing so informs management of the current status of collection actions taken, and can trigger the acceleration or alteration of collection activities.**
    c. Three-way matching. Incorrect. Three-way matching is an accounts payable control, not a collections control.
    d. Review of applied cash. Incorrect. Reviewing applied cash only impacts the cash application clerk, not the collections staff.

Chapter 7

13.   When a payment does **NOT** identify the invoice being paid:

    a. It is returned to the customer. Incorrect. It is a rare company that will return a payment to a customer without first investigating the matter in detail.
    b. **It is recorded in a suspense account. Correct. An unidentified payment is recorded in a suspense account until it can be researched.**
    c. It is retained by an independent custodian. Incorrect. An independent custodian is not needed for unidentified payments, since the check is still cashed at once – only the application of the information on the check has not yet been settled.
    d. It is paid to the state government under escheat laws. Incorrect. A payment will probably be returned to the customer rather than being paid to the state government, with a request to identify the nature of the payment being made.

14.   The advantage of applying cash from check copies is that:

    a. There is no advantage to applying cash from check copies. Incorrect. There is an advantage to applying cash from check copies, in that the checks can be deposited at once, with cash application being completed later.
    b. They are more legible than the original. Incorrect. Check copies are not more legible than the original checks, since photocopies tend to be somewhat more blurred than the text in the original checks.
    c. Check deposits can be made by the mailroom staff. Incorrect. The mailroom staff does not deposit checks; they only record a preliminary list of the checks that were received in the mailroom.
    d. **Checks can be deposited faster. Correct. The advantage of making check copies is that checks can be deposited at once, while cash application can be completed later.**

Chapter 8

15.   A bidding trail is needed to:

    a. Show that an employee found the best price before completing a purchase requisition. Incorrect. Employees do not engage in bidding in order to complete a purchase requisition; that task is given to the purchasing staff.
    b. Show that an employee was hired at the lowest possible cost. Incorrect. Employees are typically hired at a wage that matches their skills and experience, not the lowest possible cost.
    c. **Show that the purchasing staff engaged in bidding. Correct. A bidding trail shows that the purchasing staff engaged in bidding activities in order to obtain the best possible deal.**
    d. Ensure that purchase orders were fulfilled by suppliers. Incorrect. Supplier fulfillment occurs after bidding has been completed.

16.   It is essential to review open purchase orders:

    a. **To ensure that materials are received in time for operations to run smoothly. Correct. Open purchase orders must be reviewed to ensure that materials are received in time for operations to run smoothly. Otherwise, it is possible that a supplier is not capable of delivering ordered goods in a timely manner, and has not informed the company of this issue.**
    b. To ensure that suppliers are billing the correct prices. Incorrect. Reviewing a company's own purchase orders does not reveal the prices that suppliers will bill to the company.
    c. Since they are so closely linked to sales orders. Incorrect. There is no link between sales orders and purchase orders, since sales orders come from customers and purchase orders are issued to suppliers.
    d. Within the first week of issuance. Incorrect. The review dates for purchase orders depends upon how soon the ordered materials are needed

Chapter 9

17. Three-way matching is designed to:

    a. Involve at least three approvers in each supplier payment. Incorrect. One approver is sufficient for a typical supplier payment, which can be either the purchasing staff or the check signer.
    b. Ensure that there is sufficient funding for a prospective purchase. Incorrect. To verify funding for a purchase, one can compare year-to-date expenditures to the annual budget for a designated expense.
    c. Verify that a supplier invoice is authorized for payment and that the billed items were received. Correct. Three-way matching uses a purchase order to verify that an invoice is authorized for payment, and a receiving report to ensure that the billed items were received.
    d. Ensure that a check should be paid. Incorrect. A package of supporting materials is used to ensure that a check should be paid, usually including the authorizing purchase order and supplier invoice.

18. An invoice numbering guideline is useful when:

    a. There is an early payment discount involved. Incorrect. The presence of an early payment discount does not impact the recording of an invoice number.
    b. There are unique invoice numbers. Incorrect. A unique invoice number is entered into the accounts payable system as is, so no guideline is needed.
    c. Invoice numbers have trailing zeroes. Incorrect. Invoice numbers with trailing zeroes must be entered as is, or else the numbers will not match those issued by suppliers.
    d. Invoice numbers have leading zeroes. Correct. An invoice numbering guideline is useful when the payables staff needs to know whether to drop leading zeroes from invoice numbers.

Chapter 10

19. A valid control for a cash payment by an employee is:

    a. Avoided with a policy of not requiring any receipts. Incorrect. Not requiring a receipt is the absence of a control. Instead, employees can expect reimbursement for any claim.
    b. To explicitly deny reimbursement for cash payments. Incorrect. Denying reimbursement for a cash payment is a policy, not a control.
    c. To pay it with a check. Incorrect. The form of reimbursement made to an employee is not relevant to the control over the initial payment by the employee.
    d. To have them submit a receipt. Correct. A valid control for a cash payment by an employee is to have them submit a receipt. A receipt is a form of evidence that an expenditure was made.

20.   A computerized expense reporting system:

    a. Can dispense with a standard printed expense reporting form. Correct. There is no need for a printed expense reporting form when the expense reporting system is computerized, since employees enter their expense reimbursement information directly into the computer system.

    b. Requires the use of an invoice numbering procedure. Incorrect. A computerized expense reporting system assigns invoice numbers automatically.

    c. Requires the use of a detailed reporting guideline manual. Incorrect. Reporting guidelines are usually incorporated into the programming of a computerized expense reporting system.

    d. Is used for purchase requisitions. Incorrect. Purchase requisitions are not involved in a computerized expense reporting system, since they are used to order goods and services.

Chapter 11

21.   Procurement cards are assigned:

    a. To those employees most likely to make smaller purchases on behalf of their departments. Correct. Procurement cards are assigned to those employees most likely to make smaller purchases on behalf of their departments. These employees are typically charged with being the in-house purchasing person for their departments, and so are the only ones needing procurement cards.

    b. With minimal restrictions. Incorrect. Procurement cards may employ a number of restrictions to ensure that they are used only for specific purchases.

    c. Under the assumption that all users can make charges on behalf of all departments. Incorrect. Procurement card users typically only make charges on behalf of their own departments. Otherwise, a department manager has no control over the expenditures being charged against his or her department.

    d. To all employees. Incorrect. A certain amount of discretion should be used when handing out procurement cards; those employees assigned the purchasing task for their departments are usually the only ones given procurement cards.

22.   A transaction log is intended:

   a. To monitor the timing of receipt of purchased items. Incorrect. The receiving log is used to monitor the timing of receipt of purchased items.
   b. For the use of infrequent card users. Incorrect. Infrequent card users to do not need a transaction log, since they have too little receipt volume to justify the use of a log.
   c. For the use of frequent card users. Correct. Frequent card users should record their purchases in a transaction log, so they have an organized record of their purchases.
   d. To replace the credit card statement if it does not arrive. Incorrect. The transaction log is not intended to replace the credit card statement if the statement does not arrive, since the log only records transactions from the perspective of the company; those maintaining the log may have missed some transactions that are recorded on the credit card statement.

Chapter 12

23.   The amount of cash stored in a petty cash box:

   a. Is replenished every business day. Incorrect. A daily replenishment of the petty cash box would be far too time-consuming for an efficient accounting department.
   b. Should be reconciled every day. Incorrect. There should be an occasional reconciliation of petty cash, but it is not necessary to do so every day.
   c. Is kept high so that fewer replenishments will be needed. Incorrect. The cash level is generally kept low in order to make petty cash less of a target; a high balance would encourage theft.
   d. Is kept low in order to be a less tempting target. Correct. The amount of cash stored in a petty cash box is kept low in order to be a less tempting target. It is easier to steal petty cash than cash kept by the cashier, since petty cash may be stored in many unsecured locations around a company.

24.   A petty cash reconciliation:

   a. Is not needed. Incorrect. Petty cash reconciliations are needed at regular intervals, to spot inaccuracies and possible fraud situations.
   b. Should be completed once a year. Incorrect. An annual reconciliation is very minimal for petty cash, since inaccuracies and thefts may go undetected for long periods of time.
   c. Is not needed if there is only one petty cash box. Incorrect. Petty cash reconciliations should be completed for all petty cash boxes, to ensure that the custodians are documenting their distributions properly.
   d. Is used to keep the petty cash records close to reality. Correct. A petty cash reconciliation is used to keep the petty cash records close to reality on an ongoing basis.

Chapter 13

25.   Rejecting excess material at the receiving dock:

   a.   Should be required even for small variances. Incorrect. Excess material is frequently allowed for small variances when there is an expectation that the company will make use of the excess material in the near future.
   b.   Is needed when there are longer production runs. Incorrect. Rejecting excess material is more important for shorter production runs, where less material is needed.
   c.   **Is less necessary when the materials are being used on a continuing basis. Correct. Rejecting excess material at the receiving dock is less necessary when the materials are being used on a continuing basis, since the materials will be needed eventually.**
   d.   Is illegal. Incorrect. There are no statutes concerning the rejection of excess materials.

26.   Items to include on an inventory tag include the following, **EXCEPT** for:

   a.   **Price. Correct. The price is not included on an inventory tag, since pricing is handled separately.**
   b.   Unit of measure. Incorrect. The unit of measure is included on an inventory tag, since this information is needed to verify the quantity of units counted.
   c.   Description. Incorrect. The description is included on an inventory tag, since it is needed as a cross-check to ensure that the correct item is being counted.
   d.   Part number. Incorrect. The part number is included on an inventory tag, since it is needed to uniquely identify the item being counted.

Chapter 14

27.   A payroll data entry control is to:

   a.   Review gross pay calculations. Incorrect. The review of gross pay calculations is not a data entry control, since it comes after data has already been entered into the computer system.
   b.   Review the preliminary payroll register. Incorrect. Reviewing the preliminary payroll register is not a data entry control, since it comes well after data has been entered; instead, the payroll register is an outcome of data entry.
   c.   Secure check printing equipment. Incorrect. Securing check printing equipment is not a data entry control, since it is targeted at preventing improper printing of checks.
   d.   **Match entered totals to timesheets. Correct. A payroll data entry control is to match entered totals to timesheets to ensure that all data was entered.**

28.   A separate bank account is used:

    a.   To fund direct deposit payments. Incorrect. Direct deposit payments are typically funded from the central payroll bank account.

    b.   To fund cash payments. Incorrect. The cash used to make cash payments to employees may be withdrawn from any company bank account, or from its cash reserves.

    c.   To fund pay card payments. Incorrect. Pay card payments are usually withdrawn from the corporate payroll account in a single lump sum by the pay card processor, and then distributed by the processor to the individual pay cards.

    d.   For payroll to keep someone from cashing a paycheck that was fraudulently created or altered. Correct. A separate bank account is used for payroll to keep someone from cashing a paycheck that was fraudulently created or altered. This approach is used to keep the minimum possible amount of cash available for withdrawal via a payroll check.

Chapter 15

29.   An audit of depreciation calculations addresses the following, **EXCEPT** for:

    a.   The useful life. Incorrect. Useful life is audited to ensure that the depreciation expense is recognized over the appropriate period of time.

    b.   The depreciation method. Incorrect. The consistency of and reason for using a depreciation method is examined by auditors, who do not want to see inconsistent usage of depreciation methods that can result in the recognition of an unusual amount of depreciation expense.

    c.   The salvage value. Incorrect. Salvage value is reviewed by the auditors, mostly to see if the salvage value assumption is reasonable; if the salvage value is excessive, depreciation will be under-recognized.

    d.   The accounts to which depreciation is charged. Correct. The accounts to which depreciation is charged is not an audit topic, since only depreciation *calculations* are being audited.

30.   Controls over asset disposals include the following, **EXCEPT** for:

   a.   Disposition reviews. Incorrect. A disposition review is a control over asset disposal, since it ensures that a responsible party evaluates a proposed sale.
   b.   **Reviews for asset retirement obligations. Correct. A review for an asset retirement obligation is not a control over asset disposal, but rather over the amount of expense to accrue for liabilities associated with the retirement of an asset.**
   c.   Monitoring of cash receipts from sales. Incorrect. The monitoring of cash receipts from sales is a control over asset disposal, since it is used to verify that no one has absconded with the cash from an asset sale.
   d.   Signed supervisor approvals of disposals. Incorrect. A signed supervisor approval of a disposal is a control over asset disposal, since the supervisor must first review the terms of a proposed sale before signing off on it.

Chapter 16

31.   A useful control for higher-volume treasury transactions:

   a.   **Is a workflow system to route approvals to authorizing parties. Correct. A workflow system works well in a high-volume environment to route approvals to authorizing parties; otherwise, it can be difficult to ensure that all treasury transactions are approved in a timely manner.**
   b.   Is to use standard investment guidelines. Incorrect. Standard investment guidelines should be used in all treasury situations, even low-volume ones, to ensure that investments are only made in appropriate investment vehicles.
   c.   Is to use a standard investment authorization form. Incorrect. A standard investment authorization form should be used in all treasury situations, irrespective of transaction volume. By doing so, it is more likely that investments will be conducted in a consistent manner.
   d.   Is to obtain investment transaction receipts. Incorrect. Investment transaction receipts should be obtained in all treasury situations, no matter what the transaction volume may be; doing so creates evidence that transactions were entered into, and can be matched against the original investment authorizations.

32.   In a smaller organization, the following treasury control is usually **NOT** required:

   a.   Use standard investment guidelines. Incorrect. Using standard investment guidelines is required in all organizations, since it is a primary control over any treasury transaction.
   b.   Obtain transaction receipts. Incorrect. Obtaining transaction receipts is required in all organizations, since it is a fundamental control.
   c.   Reconcile investment book balances. Incorrect. Reconciling investment book balances is required in any organization, to ensure that the company's cash records match those of its bank.
   d.   Obtain interest rate quotes. Correct. Obtaining interest rate quotes is usually not required in a smaller organization, since there may be little lending activity.

Chapter 17

33.   A closing task that can be completed prior to the end of an accounting period is:

a.   Issuing final invoices to customers. Incorrect. Issuing final invoices is completed after the end of an accounting period, since they depend upon final shipping and services information.
b.   Counting inventory. Incorrect. Counting inventory is completed after the end of an accounting period, after all items have been shipped out of and received into stock.
c.   Allocating overhead to inventory. Incorrect. Allocating overhead to inventory is completed after the end of an accounting period, after all costs have been recorded.
d.   Issuing recurring customer invoices. Correct. Issuing recurring customer invoices can be completed prior to the end of an accounting period, since they are not contingent upon the completion of any other month-end activities.

34.   The period-end closing for prepaid expenses involves:

a.   Shifting all of them to expense. Incorrect. Only those items that have been consumed are charged to expense; other items may be classified as assets.
b.   Charging those items to expense that were consumed in the period. Correct. Those items that were consumed in the period should be charged to expense, rather than being incorrectly deferred into a later period as an asset.
c.   Netting them against accrued liabilities. Incorrect. Prepaid expenses are not netted against accrued liabilities; this is not allowed under accounting rules.
d.   Apportioning them to subsidiaries. Incorrect. Prepaid expenses are usually only apportioned to subsidiaries if there is a justifiable reason for doing so, such as a corporate allocation procedure.

Chapter 18

35.   A possible control over the verification of acquired asset fair values is to:

a.   Keep all fair value compilation work in-house. Incorrect. A company is unlikely to have an adequate level of in-house expertise to derive asset fair values. Instead, this work is typically shifted to third-party experts.
b.   Ensure that due diligence teams examine all assets. Incorrect. Due diligence teams should certainly examine the higher-value assets as part of their activities, but the teams do not also issue fair value appraisals of those assets.
c.   Employ a third-party valuation expert. Correct. The valuation work of a third-party expert is routinely used to derive fair values, as well as to provide a justification for the recorded amounts of these values.
d.   Use a checklist. Incorrect. A checklist is used in other aspects of acquisition accounting, such as for the derivation of restructuring expenses, but there is no need for it when accounting for fair values.

36.   The reason for auditing bill of material records is to:

   a. Ensure that they are accurate. Correct. All line items in a bill of materials must be accurate. Otherwise, the costs of the inventory items whose valuations are based on bills of material will not be correct.
   b.   Verify the amounts of overhead allocated from cost pools. Incorrect. Bills of material are not used on the allocation of overhead costs. Allocations instead use cost pools as the basis for allocation.
   c.   Ensure that obsolete inventory is identified as such. Incorrect. Obsolete inventory is not identified through bills of material, but rather through the efforts of a committee that is tasked with examining the inventory.
   d.   Ensure that cost layers are properly recorded. Incorrect. The proper recordation of cost layers can be verified with audits of the cost layer records. Cost layering is not associated with the information in bills of material.

Glossary

This is a glossary of key terms with definitions. Please review any terms with which you are not familiar.

Account reconciliation: The investigation and verification of the items stored in an account, sometimes based on information contained in a similar account maintained by a third party.

Accredited investor: An investor having a minimum net worth or annual income, who is allowed by the Securities and Exchange Commission to invest in certain unregistered securities.

Accrual: A journal entry that allows a business to record expenses and revenues for which it expects to expend cash or receive cash, respectively, in a future reporting period.

Allowance for doubtful accounts: A contra account that contains a reserve for an expected amount of bad debt that will eventually be written off.

Asset retirement obligation: A liability associated with the eventual retirement of a fixed asset, such as paying to dismantle a facility once its useful life has been completed.

Auto cash: Software that automatically applies received customer payments to outstanding accounts receivable.

Automated control: A control that is built into the computer systems used to operate a business.

Bank reconciliation: A comparison between the cash position recorded on an entity's books and the position noted on the records of its bank, usually resulting in some changes to the book balance to account for transactions that are recorded on the bank's records but not the entity's, such as bank fees and interest income.

Bill and hold: The concept of billing a customer for goods that the seller stores on behalf of the buyer.

Bill of lading: A list of the items contained within a shipment of goods. It is in the form of a receipt, and is given by the shipper to the freight carrier.

Bill of materials: A document containing the standard amount of materials and normal scrap required to manufacture a product. It typically also includes the standard costs of these items.

Buddy punching: When a third party clocks an employee in and out of a timekeeping system, even though the employee is not working.

Capitalization limit: The amount paid for an asset, above which a business records it as a long-term asset. If a business pays less than the capitalization limit for an asset, then the expenditure is charged to expense in the period incurred.

Cash forecast: A spreadsheet on which are stated the projected cash inflows and outflows of a business over the short term.

Collateral: An asset or group of assets that a borrower or guarantor has pledged as security for a loan.

Control: A means by which we gain a reasonable assurance that a business will operate as planned, that its financial results are fairly reported, and that it complies with laws and regulations.

Debit blocking: When a company prohibits its bank from allowing any ACH debits from third parties to be deducted from the cash in its bank account.

Depreciation: The gradual charging to expense of an asset's cost over its expected useful life.

Detective control: A control designed to spot control breaches after they have already occurred.

Direct deposit: The payment of an account payable, wages, or taxes directly into a bank account by means of an ACH electronic payment.

Drop shipping: The practice of having a supplier ship goods directly to a company's customers.

Evaluated receipts: A system of paying suppliers based on a combination of goods or services received and the authorizing purchase order. There is no need for a supplier invoice.

Expected loss: A method for quantifying the cost associated with a risk. It is calculated by multiplying the risk of an event (as a percentage) by the exposure if an event occurs (in dollars).

Expense report: A form completed by an employee, with attached receipts, stating the expenses that he or she paid on behalf of the company. A business uses this report as the basis for reimbursement payments to employees.

Financial statements: A collection of reports about an organization's financial condition, which typically include the income statement, balance sheet, and statement of cash flows.

Fixed asset: An item with a useful life greater than one year, and which exceeds an entity's minimum capitalization limit. It is not purchased with the intent of immediate resale, but rather for productive use within the entity.

Form 10-K: A document that a publicly-held company must file with the Securities and Exchange Commission (SEC) once a year, detailing its financial results for the preceding year. The report includes the financial statements of the company, an audit report, management's discussion and analysis of certain items, and a number of supporting exhibits.

Form 10-Q: A quarterly report that the Securities and Exchange Commission requires all publicly-held entities to file with it. The report contains reviewed comparative financial statements for the quarter and year-to-date, management's discussion and analysis of results, and various other required disclosures for material events that occurred during the quarter.

General ledger: The master set of accounts that summarize all transactions occurring within an entity.

Generally Accepted Accounting Principles: A set of authoritative accounting standards issued by several standard-setting bodies, which entities should follow in preparing their financial statements.

Ghost employee: A fake employee record to which payments are fraudulently made. It could be an entirely fabricated person, or else a former employee whose record still indicates that he is an active employee.

Impairment: A permanent decline in the value of an asset. If there is impairment, then write off the difference between the fair value of the asset and its carrying amount.

Income tax: A government tax on the taxable profit earned by an individual or corporation.

International Financial Reporting Standards: A set of authoritative standards set by the International Accounting Standards Board, which an entity must comply with if it wishes to create financial statements that are accepted in those countries mandating the use of IFRS.

Invoice: A document submitted to a customer, identifying a transaction for which the customer owes payment to the issuer.

Line of credit: A commitment from a lender to pay a company whenever it needs cash up to a pre-set maximum level.

Lockbox: A mail box operated by a bank, to which the customers of a company send their payments. The bank deposits all payments received into the company's bank account, and posts scanned images of all payments on a secure website, which the company can access.

Manual control: A control that requires a person to perform it.

Master purchase order: An agreement between a company and its supplier, under which the company commits to a certain purchase quantity within a designated period of time, usually in exchange for reduced pricing.

Negative approval: An approval technique where authorizers only notify the accounts payable department if they do not approve of the payment of a supplier invoice.

Not sufficient funds check: A check issued for which there are not sufficient funds in the issuer's bank account.

Payroll register: A summarization of the payments made to each employee in a payroll, including gross pay, deductions, and net pay.

Petty cash: A small amount of cash that is kept on the company premises for the purpose of paying for small, incidental expenditures.

Picking ticket: A printed list of items to be picked for a customer order.

Policy: A rule used to guide decisions.

Positive pay: A program under which a company sends a file containing its check payment information to its bank; if a check is presented for payment and it is not on the list of checks issued by the company, the bank rejects it.

Prepaid expense: An expenditure that is paid for in one accounting period, but for which the underlying asset will not be entirely consumed until a future period.

Preventive control: A control designed to keep a control breach from occurring.

Procedure: A series of actionable steps designed to complete a business transaction, under the guidelines set by one or more policies.

Procurement card: A credit card used to make small-dollar purchases for a business.

Purchase order: A legal document authorizing the purchase of goods from a supplier.

Purchase requisition: A form filled out by someone requisitioning goods or services, stating the items needed. The purchasing department uses this form as the basis for its purchasing activities.

Radio frequency identification: A radio transmission methodology involving the use of either passive or active radio transmission chips to track the location of assets.

Remittance advice: An attachment to a check payment, detailing the contents of the payment.

Remote deposit capture: The use of a scanning device to create a legal, scanned image of both sides of a check, which is then uploaded to a bank as a valid deposit.

Restrictive endorsement: A statement on a check payment that the payment constitutes full payment of a debt. It is intended to reduce the liability of the payer for any remaining outstanding debt.

Return merchandise authorization: An authorization granted by a seller for a buyer to return goods to it.

Reversing entry: A journal entry made at the beginning of an accounting period, which reverses selected entries made in the immediately preceding accounting period.

Risk: The possibility that an event will occur and adversely affect the achievement of planned operations, the fair reporting of financial results, or compliance with laws and regulations.

Sales order: An internal document used to document a customer order. It may be derived from a customer purchase order or some less-formal type of communication.

Sales tax: A tax imposed by the government of a city, county, or state on the retail price of a product or service.

Shipping log: A summary of shipments issued by the shipping department, usually organized by day.

Stock transfer agent: An entity that is responsible for issuing and tracking shares on behalf of a company.

Suspense account: An account in which transactions are recorded for which final disposition has not yet been determined.

Three-way matching: The comparison of a supplier invoice and related purchase order and receiving document by the accounts payable staff prior to payment.

Trade accounts receivable: Amounts billed by a business to its customers when it delivers goods or services to them in the ordinary course of business.

Trial balance: A report listing the ending debit and credit balances in all accounts at the end of a reporting period.

Vendor master file: A computer file in which is stored the key information for all suppliers with which a company has business transactions.

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Qualified Assessment
Accounting Controls Guidebook
Course # 1153298, Version 2004
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Course Expiration Date
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1.   It may be acceptable to have weak controls in one part of a business:

   a. If there is a risk of a large loss
   b. In cases where there are highly repetitive transactions
   c. If management is willing to accept lower-quality financial statements
   d. If there are offsetting controls elsewhere

2.   The best controls are ones that are:

   a. Detective and manual
   b. Detective and automated
   c. Preventive and automated
   d. Preventive and manual

3.   A particular concern with controls following an acquisition is that:

   a. Morale issues can have a negative impact
   b. The acquiree will attempt to impose its control system on the acquirer
   c. Additional funding by the acquirer will alter controls
   d. The controls will not be changed

4.   If a customer prepays an order:

   a. This is recorded by the company as an asset
   b. The order is sent to the credit department for approval
   c. The company records a sale prior to shipment
   d. The related sales order is set up for immediate fulfillment

5.   If an inventory item is not on hand, a reasonable alternative to backordering it is to:

   a.   Contact the customer about replacing it with a similar item that is in stock
   b.   Cancel the order
   c.   Design a new product
   d.   Refer the customer to a competitor

6.   A copy of the sales order is sent to the customer:

   a.   To indicate backordered items
   b.   For payment purposes
   c.   To show projected shipment dates
   d.   Who can review it for accuracy

7.   Sales order forms should be locked up:

   a.   Because they could be used to ship goods to a fake customer
   b.   Because they are expensive
   c.   Because they can be used to order goods from suppliers
   d.   Because they can be used to pay suppliers

8.   A business status test is intended to determine:

   a.   Whether a customer has sufficient credit for an order
   b.   If a customer has a foreign owner
   c.   If a customer is a fraudulent shell company
   d.   If a customer has made current tax filings

9.   A reasonable alternative to insufficient credit is:

   a.   Recommending buying from a competitor
   b.   Paying a portion of an order in cash
   c.   Asking for a revised customer purchase order
   d.   Recommending purchasing an alternative product

10.   A credit waiver is used:

   a.   When senior management does not want a credit review
   b.   For shipments to related parties
   c.   For backordered items
   d.   For small-dollar orders

11.   When credit is reviewed, the shipping department receives:

    a. A copy of the sales order from the credit department
    b. A copy of the sales order from the order entry department
    c. A copy of the customer purchase order from the order entry department
    d. A copy of the customer purchase order from the accounts payable department

12.   The issuance of a not sufficient funds check:

    a. Should be found during a sales order reconciliation
    b. Reflects poorly upon the financial condition of the issuing bank
    c. Should trigger a credit extension
    d. Can trigger a credit hold on the customer issuing the check

13.   The shipping log is used:

    a. To remind the shipping manager of which items are to be shipped each day
    b. To review orders for credit approval
    c. To summarize shipments made
    d. To relieve items from the inventory records

14.   Matching picked items to the sales order:

    a. Is a cross-check on the efficiency of the picking team
    b. Is a key credit verification step
    c. Ensures that the customer will receive what was ordered
    d. Is designed to spot mislabeled products

15.   The control system for drop shipments:

    a. Involves on-site inspections
    b. Is similar to the controls used for a manual shipping situation
    c. Requires excellent electronic links with the supplier
    d. Requires a controls manager on-site at the supplier

16.   Reconciling backordered items:

    a. Is used to see if backordered items can be filled soon, before customers cancel the orders
    b. Is an important fraud control
    c. Is the primary control over drop shipped goods
    d. Is used to see if credit stamps were used on sales orders

17.　　The return merchandise authorization is used to:

    a.　Initiate the issuance of an invoice to a customer
    b.　Set up an item to be backordered
    c.　Trigger a price discount
    d.　Initiate the issuance of a credit memo to a customer

18.　　Invoice proofreading is especially important:

    a.　For small-dollar invoices
    b.　For large-dollar invoices
    c.　For routine fulfillment orders
    d.　When the billing system contains automated validation routines

19.　　An unmatched bill of lading indicates that:

    a.　No invoice was created for the associated shipment
    b.　A freight bill has not yet arrived
    c.　No related entry was made in the shipping log
    d.　A supplier has not yet delivered goods that had been ordered by the company

20.　　In a manual billing environment, the billing clerk:

    a.　Should not review for extra bills of lading
    b.　Does not need to verify special pricing
    c.　Should make an extra sales order copy for backordered items
    d.　Does not need to proofread invoices

21.　　The collections manager should assign accounts to the collections staff:

    a.　Even when they are referred directly to an attorney
    b.　Even when the customer prepays
    c.　Even when they are referred directly to a collection agency
    d.　Based on account assignment guidelines

22.　　A formula change for calculating the allowance for doubtful accounts requires the approval of:

    a.　The controller
    b.　The outside auditors
    c.　The internal auditors
    d.　The audit committee

23.   In collections, the sales manager is notified when:

   a. An overdue invoice is being shifted to a collection agency or attorney
   b. A cash payment is received
   c. A new collections person is assigned to an account
   d. A new update is made to the allowance for doubtful accounts

24.   A cash receipt is pre-numbered in order to:

   a. Assist with use of the cash register
   b. Track usage of the expensive forms
   c. Ensure that customers all received a copy of their receipt
   d. Determine if cash has not been recorded in the accounting system

25.   It is reasonable to destroy a check:

   a. To avoid the risk of theft
   b. When a check payment cannot be applied to an invoice
   c. When it comes from a foreign location
   d. In order to avoid the risk of a double deposit when remote deposit capture is used

26.   Cash controls can be reduced by:

   a. Having customers pay by ACH
   b. Converting entirely to cash payments
   c. Converting entirely to check payments
   d. Having one person handle all cash-related tasks

27.   The budget can be a purchasing control:

   a. When it controls the staffing of the purchasing department
   b. Near the beginning of each budget year
   c. When purchases are matched against budgeted funding
   d. Solely in for-profit enterprises

28.   The purchase order is matched to the purchase requisition:

   a. To show a complete bidding trail
   b. To show that the item requested was ordered
   c. To show the approval of the purchasing manager
   d. To obtain the approval of the requesting employee

29.   Purchase orders should be pre-numbered on forms when:

   a. They are created through a computer system
   b. They are considered a secondary form of authorization

    c. There are no circumstances where pre-numbering is required
    d. They are created manually

30. A supplier naming convention is needed:

    a. To avoid duplicate supplier records
    b. To avoid multiple sales tax payments
    c. To assign different names to employees for expense report payments
    d. When the number of suppliers exceeds 100

31. Supplier certification can involve:

    a. Examining their propensity to take early payment discounts
    b. Visiting supplier facilities
    c. Setting up vendor master file records for them
    d. The number of winning bids they received from the company in the recent past

32. The evaluated receipts system is designed to:

    a. Require an enhanced level of receiving examination
    b. Pay for most supplier deliveries in advance
    c. Avoid the need for a supplier invoice
    d. Operate in an entirely manual manufacturing environment

33. Recording a supplier invoice prior to its approval places an emphasis on:

    a. Only paying invoices that have been approved
    b. Ignoring early payment discounts
    c. Paying through an evaluated receipts system
    d. Paying suppliers on time

34. If checks are signed with a signature plate:

    a. This is less efficient than manual check signing
    b. There is no risk associated with loss of the signature plate
    c. There should be a strong purchase order system to offset the nonexistent signing control
    d. The control system can tolerate a weak purchasing system

35. A cost-effective control over a recurring payment is to:

    a. Require a new purchase order for each payment
    b. Audit it to verify that it should still be paid
    c. Pay the entire amount in advance
    d. Require a new purchase requisition for each payment

36.   An invoice numbering method may be required for expense reports:

    a. Because they frequently do not contain an invoice number
    b. Because it is difficult to distinguish the reports submitted by different employees
    c. In order to set the payment priority for the expense reports
    d. Based on the amount of reimbursement submitted

37.   A control over small employee expenditures for which no receipt is required is to:

    a. Occasionally surprise employees after-the-fact with a demand for receipts
    b. Track the total amount of these claims by employee to look for unusual amounts
    c. Require that they be bought with procurement cards
    d. Admit that there is no viable control over such purchases

38.   It is important to review hotel billings:

    a. To recapture frequent user awards
    b. To ensure that charges are made to the correct expense accounts
    c. For additional charges not reimbursed by the company
    d. For the correct hotel remit-to address

39.   A standard account code list is issued to procurement card users:

    a. To reduce the number of items purchased
    b. So that they will charge expenses to the accounts on the list
    c. To encourage them to charge expenditures to asset accounts
    d. To show the bank accounts from which payments will be made

40.   An expenditure protest form:

    a. Is used to protest a charge on a procurement card statement
    b. Is used to notify management of a lost procurement card
    c. Is used to notify management of a missing receipt
    d. Is used to state that an expenditure should be charged to a different department

41.   The accounting for petty cash involves:

    a. Charging expended cash to expense, based on receipts
    b. Charging funds to expense as soon as they are shifted to a petty cash box
    c. Recording it as a prepaid expense until proven otherwise
    d. A daily reconciliation of the account

42.   A payment from petty cash:

    a. Does not need to be documented, since the amounts involved are so small
    b. Is the responsibility of the controller
    c. Is allowed for virtually any type of expense item
    d. Should be swapped for a receipt

43.   A replacement for petty cash is:

    a. Procurement cards and employee expense reports
    b. Purchase orders for all purchases
    c. Purchase requisitions for all purchases
    d. Not possible

44.   In the absence of the petty cash custodian:

    a. The petty cash box should be returned to the cashier
    b. Petty cash can still be used on the honor system
    c. The petty cash box should be locked
    d. The controller should administer the petty cash box

45.   Password protection of receiving software:

    a. Has no control purpose
    b. Keeps people from accessing the vendor master file
    c. Keeps people from accessing the customer master file
    d. Is needed to prevent the fraudulent logging of a delivery as received

46.   Buddy punching can be eliminated:

    a. With a biometric time clock
    b. With an internet-based time clock
    c. With a manual time clock
    d. With a smartphone-based time clock

47.   Locking up undistributed checks:

    a. Means that they should still be recorded within the cash account
    b. Means that they should be recorded as prepaid expenses
    c. Is only useful for supplier checks, not payroll checks
    d. Mitigates the risk of theft of the checks

48. Employees are most likely to certify their time sheets:

    a. When required to by a government contract
    b. When subject to a garnishment
    c. For child support payment calculations
    d. When including vacation time in their time sheets

49. Someone who receives a fixed asset:

    a. Should not be allowed to record the transaction
    b. Can be involved in all aspects of fixed asset ownership
    c. Has no way of committing fixed asset fraud
    d. Should have a second person forward the receiving documents to the accounting department

50. A good time to revise the construction of the cash forecast spreadsheet is:

    a. Once a week
    b. When the company is restructured
    c. Daily
    d. Only at the behest of the auditors

51. Actual funds transfers should be reconciled:

    a. At month-end
    b. Weekly
    c. As soon as possible each morning
    d. At the same time as the monthly bank reconciliation

52. Reviewing collateral requirements:

    a. Is done to see if there are conflicting collateral obligations
    b. Is done to see if collateral requirements have expired
    c. Is a standard annual internal audit task
    d. Is not required if there are multiple loans outstanding

53. A letter of direction is used to:

    a. Hire employees
    b. Fire employees
    c. Purchase investments
    d. Issue company stock

54. A restrictive legend is added to stock certificates:

    a. If they are registered
    b. If they are not registered
    c. If the recipient has not paid a stock issuance fee
    d. As a form of company advertising

55. For treasury activities, a clearing account:

    a. Is used to temporarily store unidentified customer payments
    b. Is only funded for wire transfers and ACH payments
    c. Is used to process incoming payments from investors for stock
    d. Is not used

56. A closing task that is typically completed after the end of an accounting period is:

    a. Updating reserves
    b. Issuing recurring customer invoices
    c. Accruing vacation expenses
    d. Consolidating division results

57. An independent reviewer is useful for:

    a. Examining financial statement disclosures
    b. Accruing earned vacation
    c. Accruing contingent liabilities
    d. Counting inventory

58. A problem with custom financial reports in an accounting package:

    a. Is that they require constant updating
    b. Is that they take longer to issue
    c. Is that some accounts will not be included
    d. Is that they are more difficult to reconcile

59. To be certain that a manager has received the final version of the budget:

    a. Verify that the budget has been approved
    b. Put the words FINAL BUDGET in the footer of every page and have the manager sign a receipt
    c. Print and bind the final version
    d. Provide only the latest iteration.

60. A project monitoring plan might include a progress measurement for:

   a. The remaining hours required to complete a project
   b. The amount of accountant staff hours charged to a project
   c. The amount of overtime charged to a project
   d. The number of times the expected outcome has been changed

Answer Sheet
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5. ___	17. ___	29. ___	41. ___	53. ___
6. ___	18. ___	30. ___	42. ___	54. ___
7. ___	19. ___	31. ___	43. ___	55. ___
8. ___	20. ___	32. ___	44. ___	56. ___
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10. ___	22. ___	34. ___	46. ___	58. ___
11. ___	23. ___	35. ___	47. ___	59. ___
12. ___	24. ___	36. ___	48. ___	60. ___

Course Evaluation
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1. Please answer the following related to the content of the course:

	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
The stated learning objectives were met.	O	O	O	O	O
The course materials were accurate, relevant, and contributed to the achievement of the learning objectives.	O	O	O	O	O
The stated prerequisites were appropriate and sufficient.	O	O	O	O	O
Based on 50 minutes per credit hour, the time to take this course accurately reflects the credit hours assigned to it.	O	O	O	O	O
The instructor was knowledgeable and effective.	O	O	O	O	O

2. Were there any questions you felt were confusing or had incorrect answers listed? If so, please give the question number and a brief description of the issue:

3. Please provide any additional comments specific to the educational content or author of this course:

4. Do you have ideas for future course topics? If so, please list them along with any known subject matter experts we might contact to develop the course:

Customer Experience

5. Please rate your overall experience with Western CPE:

	Unsatisfactory	Improvement Needed	Meets Expectations	Exceeds Expectations	Exceptional
If you interacted with our Customer Service team, please rate the quality of service you received.	O	O	O	O	O
If you purchased your course online, please rate the quality of your e-commerce experience.	O	O	O	O	O
"My Account" information includes the tools necessary to access courses and track those completed.	O	O	O	O	O

6. Please indicate the likelihood of your purchasing the listed course formats from Western CPE:

	Not at all	Not very likely	Possibly	Likely	Highly Likely
Self-Study	O	O	O	O	O
Webcast OnDemand	O	O	O	O	O
Live Webcast	O	O	O	O	O
Resort Conference or Seminar	O	O	O	O	O

7. Please use the box below to provide any additional comments related to your educational experience with Western CPE.

8. If you are willing to provide a quote about this course, or Western CPE in general, that we may use in our promotional materials, please state it below. Be sure to include your name, title, city, and state.