

CHAPTER 5

THE EXPENDITURE CYCLE – Part I

Businesses need resources in order to conduct their business—to produce and sell a product or to provide a service. The *expenditure cycle* is concerned with the acquisition of fixed assets, raw materials, or manufactured components and the use of employee labor to yield a finished product. As was the case in the revenue cycle, this effort can be viewed as having both a *physical* phase and a *financial* phase.

This chapter examines the *purchases processing subsystem* and the *cash disbursements subsystem*. Chapter 6 will examine the *payroll subsystem* and the *fixed-asset subsystem*.

In many ways, the purchasing system is a mirror image of the revenue system.

The objectives of this chapter are:

- to recognize the fundamental tasks that must be performed in the purchasing and cash disbursement processes;
- to be able to identify the departments involved in purchasing and cash disbursement activities and trace the flow of expenditure transactions through the organization;
- to be able to specify the documents, journals, and accounts that provide audit trails, promote the maintenance of historical records, support internal decision making, and support financial reporting;
- to understand the exposures associated with purchasing and cash disbursements and to recognize the controls that reduce these risks; and
- to be aware of the operational features and control implications of technology used in purchasing and cash disbursement subsystems.

I. Overview of Purchasing and Cash Disbursement Activities

In many ways, the *expenditure cycle* mirrors the revenue cycle. For one firm to sell something, another must buy.

A. Purchases Processing System

Fig. 5-1, on page 247, is a data flow diagram of the purchases system. This presents the activities of the system in terms of the six basic processes that must be performed. As is true of all DFDs, this does not show the *way* in which the processes are carried out. This DFD is technology neutral.

B. A Manual System

Fig. 5-2, on page 249, is the document flow chart of a manual purchasing subsystem. The narrative describes the work done by the various entities involved. Note that some of these entities are not part of the accounting function, although each plays a very important role in the whole process.

- The first step in the purchasing cycle occurs when it is decided that inventory needs replenishment. In a manufacturing environment, this would occur in the production planning department. The example developed in the book involves a merchandising firm. In this type of business, **inventory control** is responsible for determining when to reorder inventory. This involves determining the need and preparing a **purchase requisition** or request. This document is sent to the purchasing department for action and to accounts payable for information purposes. Another copy is kept in the open purchase requisition file in the inventory control department for monitoring.
- It is the job of the **purchasing department** to actually place the order and work with vendors to secure the needed items. This department will prepare a **purchase order** which is sent to the vendor to initiate the order. Other copies go to inventory control to confirm that the order was placed, to accounts payable, and a special copy goes to receiving. This copy is “blind” in that it shows the items ordered but not the quantities. This is to force a count of goods

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- when received. Naturally purchasing keeps a copy.
- When the vendor acts on the purchase order, the next internal department involved in a purchase is **receiving**. When the goods are received, the people in receiving reconcile the items in the shipment with the blind copy of the purchase order. When this is complete, a **receiving report** is prepared showing the quantity and condition of the goods received. One copy goes with the goods to wherever they are stored: the storeroom if raw materials or the finished goods warehouse. Other copies go to purchasing, inventory control, and accounts payable.
 - By this point in the process, accounts payable has received copies of the purchase requisition (goods were needed), the purchase order (goods were ordered), and the receiving report (goods were received). These will be kept on file until a **vendor invoice** is received. When it is, accounts payable will reconcile all four documents, record the purchase in the purchases journal, and record the liability to the vendor in the accounts payable subsidiary ledger. The documents are then moved to the **open accounts payable file** to await payment.

A number of document samples are provided. If you are not familiar with these, note in particular **what information** is included. Ask yourself what you would need to know to carry out a given process. Note also the **files** created and the **documents** prepared.

In this discussion, two methods of handling payables are presented: a traditional *accounts payable* system and a *voucher payable* system, which provides better control of cash disbursements. Study the two methods thoroughly.

C. The Cash Disbursements System

The three processes that make up a cash disbursement system are represented in the DFD of **Fig. 5-11, on page 258**. Cash is a very vulnerable asset. You must understand what happens in each of these three processes, especially why certain tasks are performed in different departments.

D. Manual System

The related document flow chart is shown in **Fig. 5-12, on page 259**. Three departments are involved in this subsystem: accounts payable, general ledger, and cash disbursements. The actual preparation of the check is not the job of an accounting department.

- In **accounts payable** outstanding obligations are reviewed daily. When the time arrives to make a payment, the documents are sent to the cash disbursement department as a request for payment. The supplier's account is updated and the general ledger informed.
- **Cash disbursements** prepares the check and makes an entry in the register or cash disbursements journal. The check and supporting documents go to the department manager or treasurer for signature. The check is mailed to the vendor and a copy, with the documents, is returned to accounts payable. A journal voucher is sent to the general ledger.
- **General ledger** updates the cash and accounts payable control account and reconciles the subsidiary ledger.

E. Expenditure Cycle Controls

As you might expect, control is extremely important in this subsystem. If unnecessary items are purchased or excessive prices paid, organizational resources are squandered. Cash itself is very liquid. Its payment must be carefully guarded. **Table 5-1, on page 261**, presents the key control points in the purchases and cash disbursements subsystems, following the SAS 78 approach.

As was the case with control in the revenue cycle, it is important for you to understand how each control area affects the subsystems of the expenditure cycle.

II. Computer-Based Purchases and Cash Disbursement Applications

As was the case with the revenue cycle, after discussing **what** must occur and illustrating the steps in a manual system, the focus shifts to **how**. There are different approaches to automation.

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A. Automating Purchases Procedures Using Batch Processing Technology

The discussion of a batch purchasing system revises Fig. 5-2 to show the work being done in data processing. **Fig. 5-14, on pages 264-5**, reflects the changes. Focus in your reading on the steps taken in data processing. Things that occur in other places are supported by the data processing activity. This involves people from inventory control, purchasing, receiving, and payables. **Fig. 5-15, on page 267**, shows the record structures of files used in purchasing. Note that the record labeled “inventory master file” is the master file of individual inventory item records, not the inventory control account.

B. Cash Disbursements Procedures

The discussion of cash disbursements focuses on the use of the voucher system. Follow the narrative carefully.

C. Reengineering the Purchases/Cash Disbursement System

Fig. 5-17, on page 270, shows a reengineered system that uses current technology to eliminate the problems that complicated the effort under both manual and batch systems.

D. Control Implications

Control is always an issue when a subsystem is automated. Much of what was presented in the revenue chapter applies here. The discussion is limited to the elements of the purchasing system which are unique.

For the automated systems, improved inventory control, better cash management, time, and logistics issues are identified. For the reengineered system discussed at the end, access and separation of duties are a concern.

Review Questions for Chapter 5: 1-12

Discussion Questions for Chapter 5: 1-10