Audit, Business Processes and Digitalization [BL 5]

Business Level II | CA Sri Lanka

Study Text

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Contents of the Curriculum

PART B: BUSINESS PROCESSES AND INTERNAL CONTROLS

B.2: Procurement Cycle Management

Doing business or running an organization is a series of activities/multiple activities carried out to achieve business goals/objectives. Activities carried out on 'PURCHASES or PROCUREMENT' is one such prime series of activities carried out by most of the organizations as procurement is one of the major activity which involves purchase of raw materials, acquiring services, purchase of general items as well as long term assets.

Notes:

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B.2.1. The procurement process

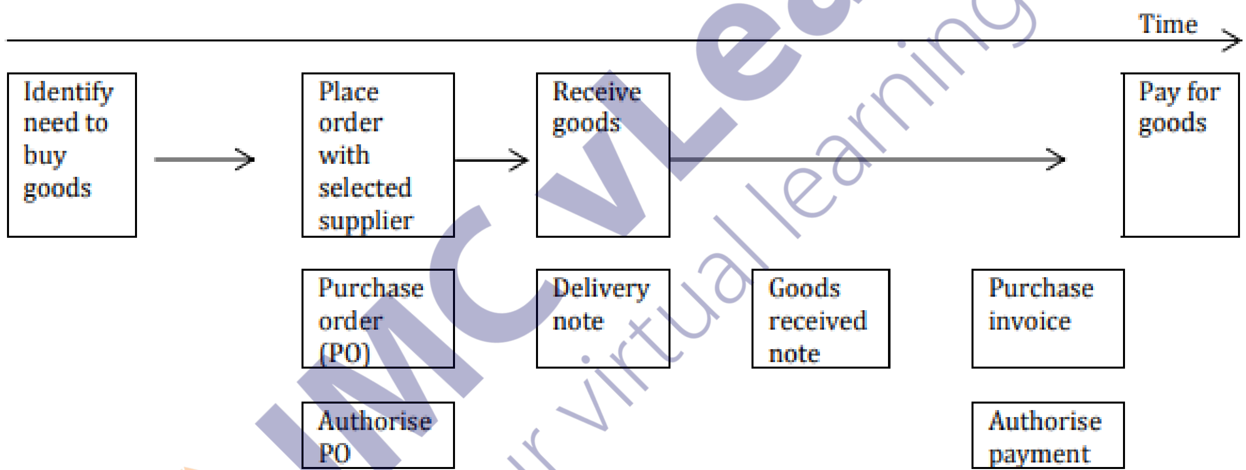
Activities within the procurement cycle are supplier selection, placing orders within budgetary control limits, receiving delivery of the goods and paying for them

The procurement process or procurement cycle is a term for the process of purchasing goods (or services) from suppliers, receiving the goods and paying for them. In this chapter, we are concerned with goods (or services) that are purchased and used regularly by the business organization

The cycle consists of:

- A series of actions
- A number of documents
- Authorization procedures

An overview of the cycle is shown below. The documents produced during the cycle and some controls that may operate are shown in the lower part of the diagram. Note that the supplier will produce the delivery note that accompanies the goods whereas the company ordering the goods will raise the Goods received note as an internal record that the goods were received



B.2.2. Supplier selection

There should be a supplier selection process for all major items purchased, and for new suppliers of these items. The selection process should include measures to check the operational reliability and financial stability of the supplier

Items that the organization buys regularly and in large quantities, there should be a process of selecting one or more suppliers. Deciding whether to use just one supplier, or whether to have two or more possible suppliers, should depend on several factors:

What are the expected purchase quantities?	Are the anticipated purchase quantities more than a single supplier can reasonably be expected to provide?
Getting the lowest price	If the main requirement is to obtain the lowest price, or the best possible supply terms, from a supplier, it may be appropriate to use several suppliers. For each purchase order, the lowest-cost supplier can be selected.
Getting reliable supply	If the main consideration is to use a supplier who can be trusted to deliver supplies on time and to the required quality standard, it may be appropriate to use one supplier. A long-term relationship can be developed with the supplier, built on trust.
Delivery locations	If an organisation has several delivery locations around the world, it may be appropriate to select a different supplier for each location, especially if the goods have to be transported by sea.

Supplier selection and evaluation

Arrangements with suppliers may be formalized in a purchase agreement. Alternatively, new suppliers may be added to a list of approved suppliers

When suppliers are selected for the first time, there should be a selection process

There are various ways of identifying possible new suppliers:

- Knowledge of the industry
- Recommendations from other users of the supplier
- Approach by sales representatives of a supplier
- Through the internet

Supplier evaluation process

Issue to evaluate?	Method of evaluation
Is the supplier reliable? Does it have the capability to produce goods in the quantities required?	Ask the supplier to provide references from other customers. It may also be appropriate for the organisation's buyer to visit the supplier's production centre to inspect the facilities.
Is the supplier financially stable? Is there a risk that the supplier will become insolvent (and so unable to supply goods)?	Ask the supplier to provide a reference from its bank. It may also be possible to obtain financial information from the supplier, such as a copy of its financial statements. Financial information from the supplier should be analysed.
Can the supplier deliver goods to the quality standard required?	Ask the supplier to provide samples of its goods. Obtain quality testing reports from independent authorities if available.
Ethical issues. The organisation may have a policy that it will not buy goods from suppliers that use child labour or treat workers badly.	Ask the supplier to confirm in writing that it does not use child labour and provides reasonable working conditions for employees.

B.2.3. Budgetary controls in purchasing

There should be budgetary controls over purchase quantities and prices. The budgetary control reporting system should ensure that significant differences between actual and budgeted purchase quantities or price are reported to management for investigation

Purchasing should be made within agreed budgetary limits. An annual budget should include a purchases budget, which includes plans for purchase quantities of goods and expected purchase prices.

If the organization has a dedicated purchasing department, the head of purchasing will be made responsible for the budget and trying to ensure that actual purchases are consistent with the budget

Control measure	
In a large buying department, buyers should specialise in the purchase of particular types of goods.	Buyers should have a thorough knowledge and understanding of suppliers in the market and available prices and supply terms. This should make buying more efficient.
Buyers should be made aware of the expected quantities and budgeted purchase prices.	If a purchase requisition is received that seems unusually high, or if a supplier quotes a price that is well in excess of the budgeted price, the buyer should refer the matter to the head of purchasing for approval.
There should be regular reporting to purchasing management, comparing actual purchases with the budget.	Management should investigate and take action when actual purchase quantities and prices differ by more than an acceptable tolerance limit from the budget.
Budgetary control reports to senior management should include variance reports on purchase quantities and price.	Regular budgetary control reports to senior management should help management to control operations.

B.2.4. Placing orders and receiving delivery

The purchase process should begin with an authorized purchase requisition. A purchase requisition note should be submitted to the purchasing department. It should contain details of the goods required (items and quantity). It may also include an indicative or estimated price for items that are not purchased regularly

A purchase order to a supplier should be made by an authorized person. In a large organization, this will be a person in the buying department with authority to purchase goods up to a specified value limit. In a smaller organization, the authorized person may be a senior manager

Purchase requisition

A purchase requisition is a formal request for the purchase of a quantity of a specified item. The purchase requisition is sent to the purchasing department, authorizing the purchasing department to make the purchase. The purchase requisition must be signed (approved) by an authorized person. This acts as a control to prevent unwanted or unnecessary purchases

PURCHASE REQUISITION Req. No.

Department/job number: Date

Suggested supplier:

Requested by:

Latest date required:

Quantity	Code number	Description	Estimated cost	
			Unit	Rs.

Prepared by:

Checked by:

Authorised by:

The duties of the preparation of the requisition, the check before authorization and the authorization should be segregated. It could be that the checks are completed on electronic documents and the relevant computer system logs the person preparing and checking the document. This applies to all documents shown throughout the chapter

Purchase order

The purchasing department prepares a purchase order, which is sent to the supplier. (The supplier may be asked to return an acknowledgement copy as confirmation of their acceptance of the order.) There should be several copies of the purchase order. A copy should be:

- Retained in the purchasing department
- Sent to the accounts department
- Sent to the storekeeper or the manager who made the purchase requisition

Purchase Order/Confirmation

Our Order Ref: Date

To

(Address)

Please deliver to the above address

Ordered by:

Total Order Value Rs.

		Subtotal		
		VAT (@ 12%)		
		Total		

Prepared by:

Checked by:

Authorised by:

Electronic data interchange (EDI)

When an organization makes regular purchases from a supplier, purchase orders may be submitted electronically.

A simple method of placing purchase orders electronically is to send an email with a purchase order attached.

Another arrangement is for a purchase order to be sent to the supplier directly from the buyer's computer system to the supplier's computer system, without the need for any human intervention in the process. This is possible when the computer systems of the buyer and supplier can communicate with each other by electronic data interchange or EDI

EDI is a system for 'translating' messages between computer systems, so that each system can read and understand messages sent from the other system. When a purchase order is sent from a buyer to a supplier by EDI, the supplier's system processes the order automatically, and may send an automatic acknowledgement of receipt of the order

Quotations

- The purchasing department may be required to obtain a number of quotations from different suppliers if: A new item is required that the organization has not purchased before
- The existing supplier's costs are too high and alternative suppliers are invited to quote for the contract
- The existing supplier no longer supplies the goods, or is unable to meet the required delivery time needed
- The value of the contract is high, and the buyer is required to obtain a good price

Delivery note

When the goods are delivered, the carrier provides a delivery note giving details of the items delivered. This is signed by the person taking delivery, who keeps one copy. The carrier retains a copy

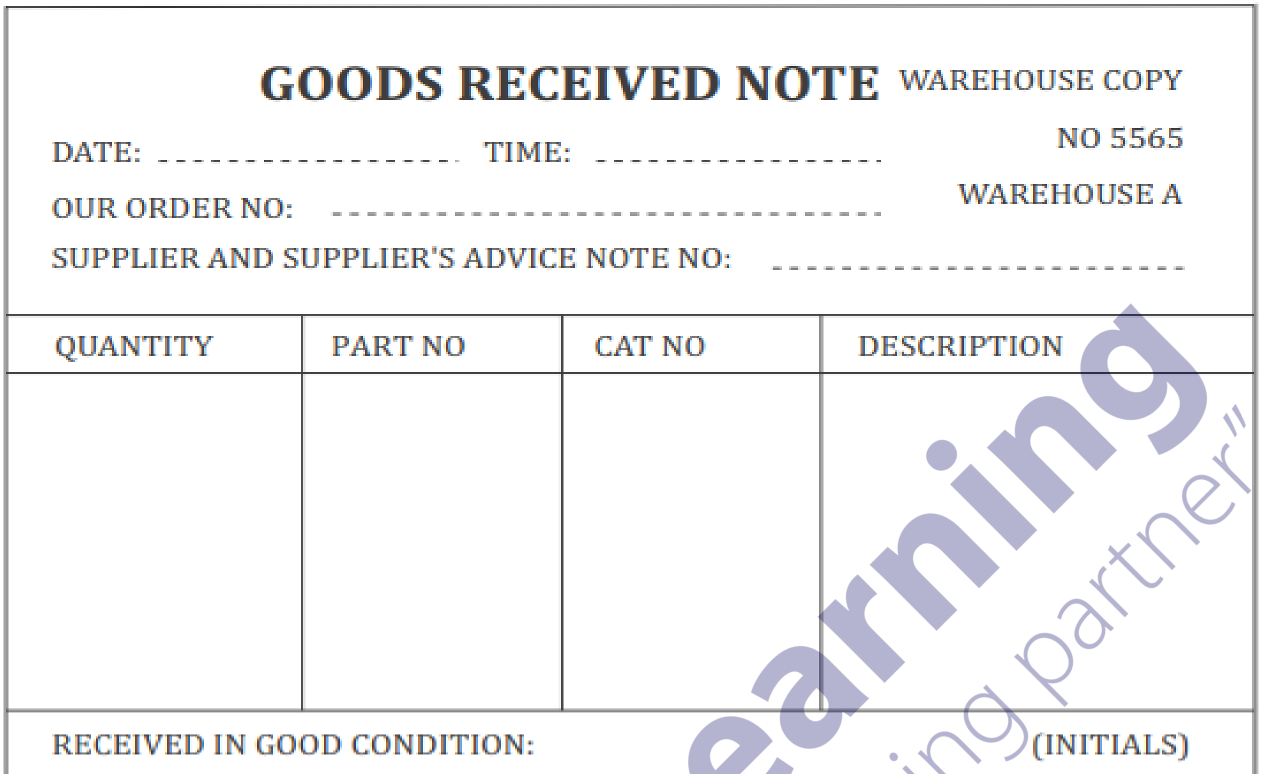
The supplier delivers the consignment of materials to the delivery address specified in the purchase order. The delivery is made by a carrier, which may be a person in the deliveries section of the supplier's organization, or an independent transport company

Before the delivery note is signed, the storekeeper should check that the physical goods delivered appear to be specified correctly on the delivery note. This is to prevent the possibility that the carrier delivers fewer goods than stated in the delivery note, or delivers goods that are inconsistent with the details in the delivery note

Goods received note

A delivery note is used by the storekeeper to prepare a goods received note (GRN) after the delivered goods have been checked in detail against the purchase order. Copies of the GRN are sent to the purchasing department and accounts department

If the delivery is acceptable, the storekeeper prepares a goods received note (GRN). This is a record showing the details of the goods received, and which also matches the goods received to the original purchase order



GOODS RECEIVED NOTE WAREHOUSE COPY

NO 5565

WAREHOUSE A

DATE: ------------------ TIME: -----------------

OUR ORDER NO: --------------------------------

SUPPLIER AND SUPPLIER'S ADVICE NOTE NO: ------------------------

QUANTITY	PART NO	CAT NO	DESCRIPTION

RECEIVED IN GOOD CONDITION: (INITIALS)

Copies of the GRN are sent to:

- The purchasing department, as confirmation that the purchase order has been fulfilled
- The accounts department, as evidence that the goods have been received: the accounts department should match the GRN with the purchase order

Debit note

Initially a debit note may be created by a buyer when returning goods received on credit. For items being returned, the total anticipated credit amount would be included on the debit note, along with details of the returned items and the reason for the return

Credit note

Supplier to initiate the credit note based on the debit note raised due to returning the goods

Accounting system updates

Purchase invoices and credit notes entered on the accounting system will normally automatically update the accounts payable control account and the individual supplier accounts (purchase ledger accounts) on the supplier master file. The control account and supplier listing will be reconciled regularly (often monthly) by the financial controller

B.2.5. Payment

Supplier invoices that have been approved for payment should be paid on the appropriate date. The person making the payment should not be the person who checked the invoice details or the person who approved the invoice

Invoices should be paid only when they have been formally approved by a person in authority. This may be the manager who submitted the purchase requisition, or the storekeeper. The detailed procedures for approval of invoices may differ between organizations. One method of approving invoices is for the authorized person to write their signature or initials on the invoice

Internal control checks	Objectives
The invoice is checked against the GRN and the purchase order	To make sure that the correct goods have been delivered, in the correct quantities and that the supplier is invoicing for the correct price.
The invoice details are checked.	An arithmetical check to make sure that the invoiced amount is correct. This is necessary when invoices are not computer-produced.
Invoice should be formally approved for payment.	To prevent improper payments.
The person checking and recording the invoice details is not the same person who makes the payment to the supplier.	Segregation of duties. This is to reduce the risk that a person will be able to make an incorrect (fraudulent) payment.

B.2.6. Other aspects of procurement

Other aspects of the procurement cycle include just-in-time (JIT) purchasing arrangements, purchasing from a foreign supplier and purchasing services rather than goods. Buying from abroad can be a slow process because imported goods must be shipped to the buyer's country and cleared through customs control

Just-in-time (JIT) purchasing

One objective of a purchasing department may be to minimize the length of the supply lead time – the time between making a purchase order and delivering the goods. A shorter lead time means that the organization can hold less inventory and, by holding less inventory, it can save on inventory holding costs

JIT purchasing to operate effectively:

- The buyer must have complete trust in the supplier to meet its delivery promises
- The supplier probably needs to hold an inventory of the items, for future orders, so that it can meet all orders from the buyer immediately

Agile supply chains

An agile supply chain is a term used to describe supply arrangements in which:

- The supply lead time is very short
- The suppliers are able to respond very quickly to changing purchase needs of the buying organization

An agile supply chain is therefore one in which suppliers can adapt very quickly. It requires very close co-operation between the supplier and the buying organization

Buying from a foreign supplier

It may be necessary for an organization to purchase goods from a foreign supplier, so that the goods have to be imported into the country.

Buying from abroad can be a slow process, because imported goods must be shipped to the buyer's country and then must be cleared through customs control

Features of buying from abroad are therefore:

- The possibility that the supplier may have to wait a long time for payment, until after the goods have been delivered to the buyer's country
- Credit risk for the supplier, who may not be certain that the buyer will eventually pay, even though the goods have been shipped to the buyer's country
- Agreeing who should be responsible for payment of shipping costs and insurance of the goods

Because of these features of selling to foreign buyers and buying from foreign suppliers, some internationally-accepted standards and payment arrangements have been developed, known as Incoterms

Incoterms

Seller and buyer may include Incoterms in their contract, defining the risks and responsibilities borne by the parties in getting goods from one part of the world to another. Incoterms cover issues relating to carriage, insurance, risk, customs documentation and duties/taxes. The risks and rewards of ownership of the goods will normally pass from seller to buyer when a seller has fulfilled all of their contractual obligations

The following seven terms can be applied regardless of the mode of transportation.

Ex works (EXW)

The seller has minimum obligations with respect to delivery. They simply have to make the goods available to the buyer at their own place of business (works).

Free carrier (FCA)

The seller fulfils their obligations when the goods have been cleared for export and handed over to the carrier named by the buyer at a named point.

Carriage paid to (CPT)

This is where the seller pays for carriage to a named location. The risk for the goods passes from seller to buyer when the goods are handed over to the first carrier.

Carriage and insurance paid to (CIP)

This is where carriage and insurance are paid by the seller up to a named destination and thereafter, the buyer assumes costs, such as import duties and other taxes. The buyer bears the risk once the goods have been passed to the first carrier

Delivered at terminal (DAT)

Under this term, the seller pays for carriage costs to a named terminal at a named destination, and for unloading from the arriving means of transport and placing the goods at the buyer's disposal. A terminal can be any place, whether it is referred to as a terminal or not, for example a quay, warehouse, container yard, or road, rail or air cargo terminal

Delivered at place (DAP)

The seller discharges their responsibilities and is no longer liable for any risks only once the goods are ready for unloading by the buyer at the agreed destination

Delivered duty paid (DDP)

This is in effect the opposite to the EXW term, which represents the minimum obligation for the seller. DDP means that the seller bears all the risk and is obliged to deliver goods to a named place in the country the goods are being imported to, with all duties relating to that importation paid

Free alongside ship (FAS)

The seller discharges their obligations when the goods have been placed alongside the ship at a named port of shipment in the country of export. The buyer bears all risk from that moment

Free on board (FOB)

The buyer makes arrangements for shipping and the seller discharges their duty by putting the goods on board the ship in the country of export. The seller does not have obligations in respect of carriage or insurance of the goods after they have placed them on board the vessel

Cost and freight (CFR)

The seller pays for all costs and freight (carriage) to take the goods to a named port of destination in the country of import, but once the goods are on board the vessel in the exporting country port, the goods become the risk of the buyer

Cost, insurance and freight (CIF)

The seller is required to bear the cost of insurance and freight (carriage) for the goods. They must contract for carriage on the usual terms for the goods to the named port of destination in the country of import by the usual route and in the way normally used for such goods

Payment methods

International sales of goods are usually paid for using: international bank transfers, international bills of exchange, or letters of credit

International bank transfers

The UN Model Law on International Credit Transfers sets out the terms on which funds are transferred from a buyer to a seller via the international banking system

Telegraphic transfers

A telegraphic transfer (TT) is an electronic method of transferring funds. It is primarily used for overseas wire transactions

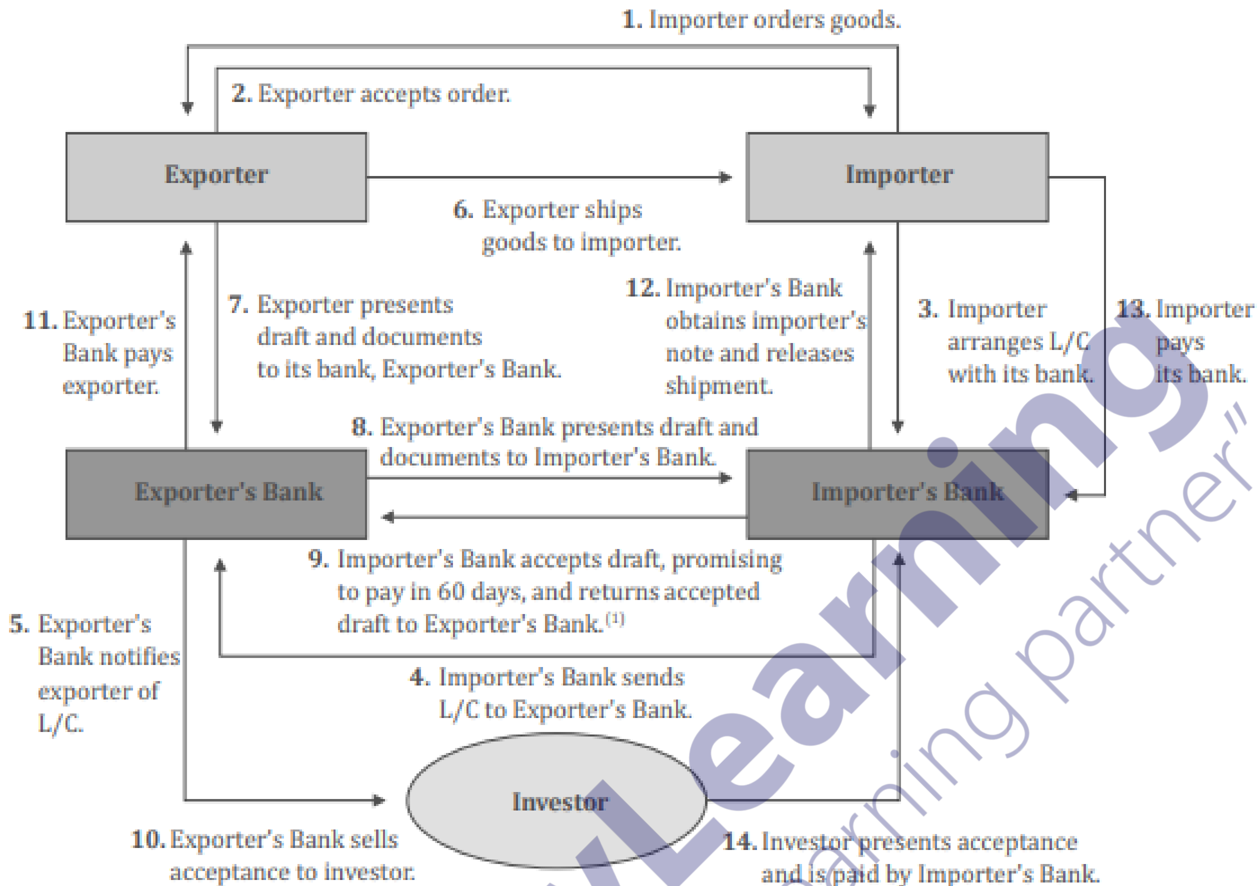
International bills of exchange (or 'Draft')

International bill of exchange is a written instrument which:

- ❑ Contains an unconditional order whereby the drawer directs the drawee to pay a definite sum of money to the payee or to his order
- ❑ Is payable on demand or at a definite time
- ❑ Is dated
- ❑ Is signed by the drawer

Letters of credit

Letters of credit (or documentary credits) provide a method of payment in international trade which gives the seller a risk-free method of obtaining payment, and which ensures for the buyer that the seller complies to the letter with the terms of the underlying sales contract



Related documentation – Bills of lading

A bill of lading is a document which is issued by a carrier to the shipper acknowledging that the carrier has received the shipment of goods and that they have been placed on board a particular vessel, bound for a particular destination

Related documentation – Shipping guarantee

A shipping guarantee enables the buyer to take possession of shipped goods without the shipping company receiving the bill of lading. The guarantee protects or indemnifies the shipping company from any loss, if the customer fails to pay. Shipping guarantees are usually arranged by banks in return for a margin or another form of payment

Related documentation – Customs declaration

A customs declaration is a statement detailing goods being imported. The declaration is often used to establish import duties payable. The recipient of the goods is responsible for the payment of duties and taxes, unless the invoice specifies that a third party should be billed

Authorizing payments

Authorization of payments for purchased goods involves checking the purchase order, goods received note and purchase invoice. If the details on these three documents agree with each other, payment can be authorized.

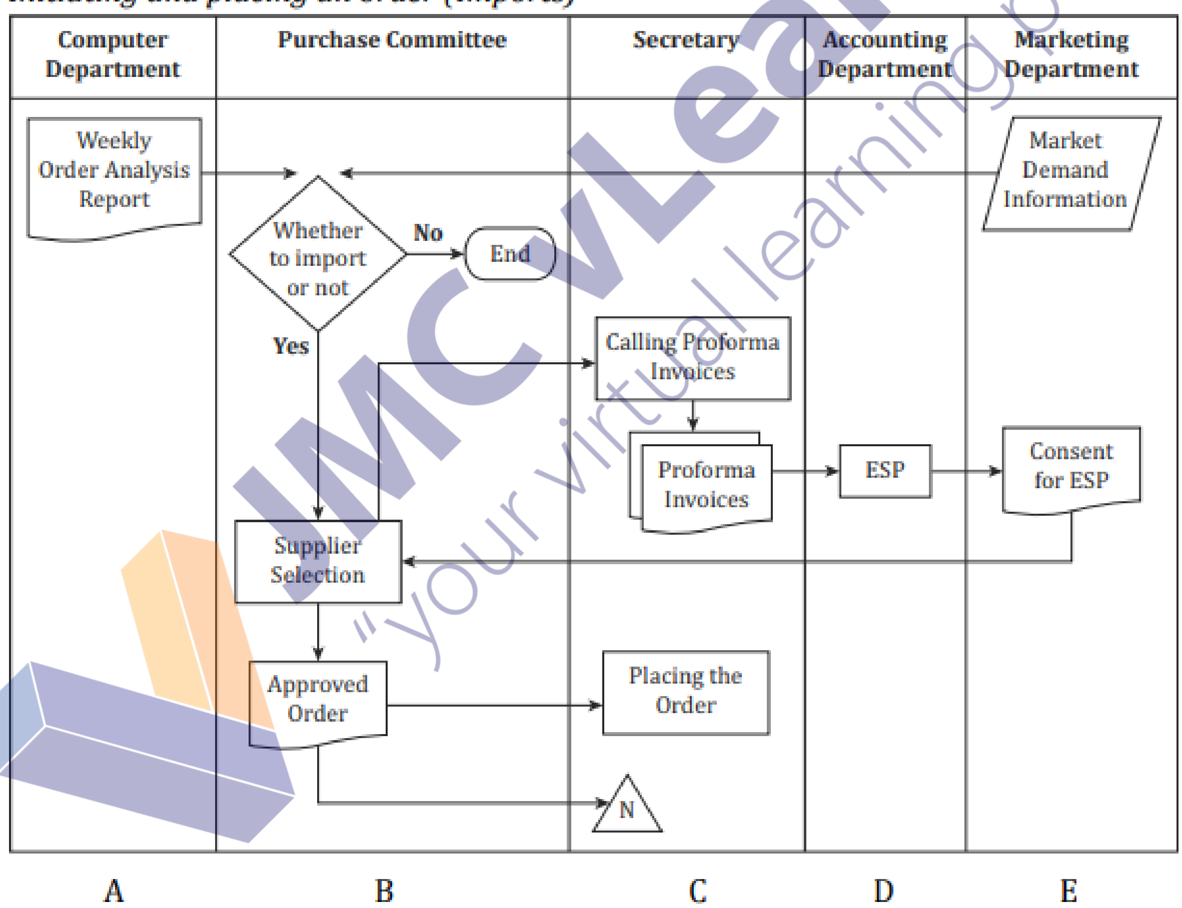
With services that have been provided, there is no goods received note. There should be a purchase order (request for services) and an invoice from the supplier. It may also be necessary to check that the service has actually been provided before payment is authorized

B.2.7. Examples of purchasing processes

- ***Order processing: initiating and placing the order***

The process is represented in the following diagram

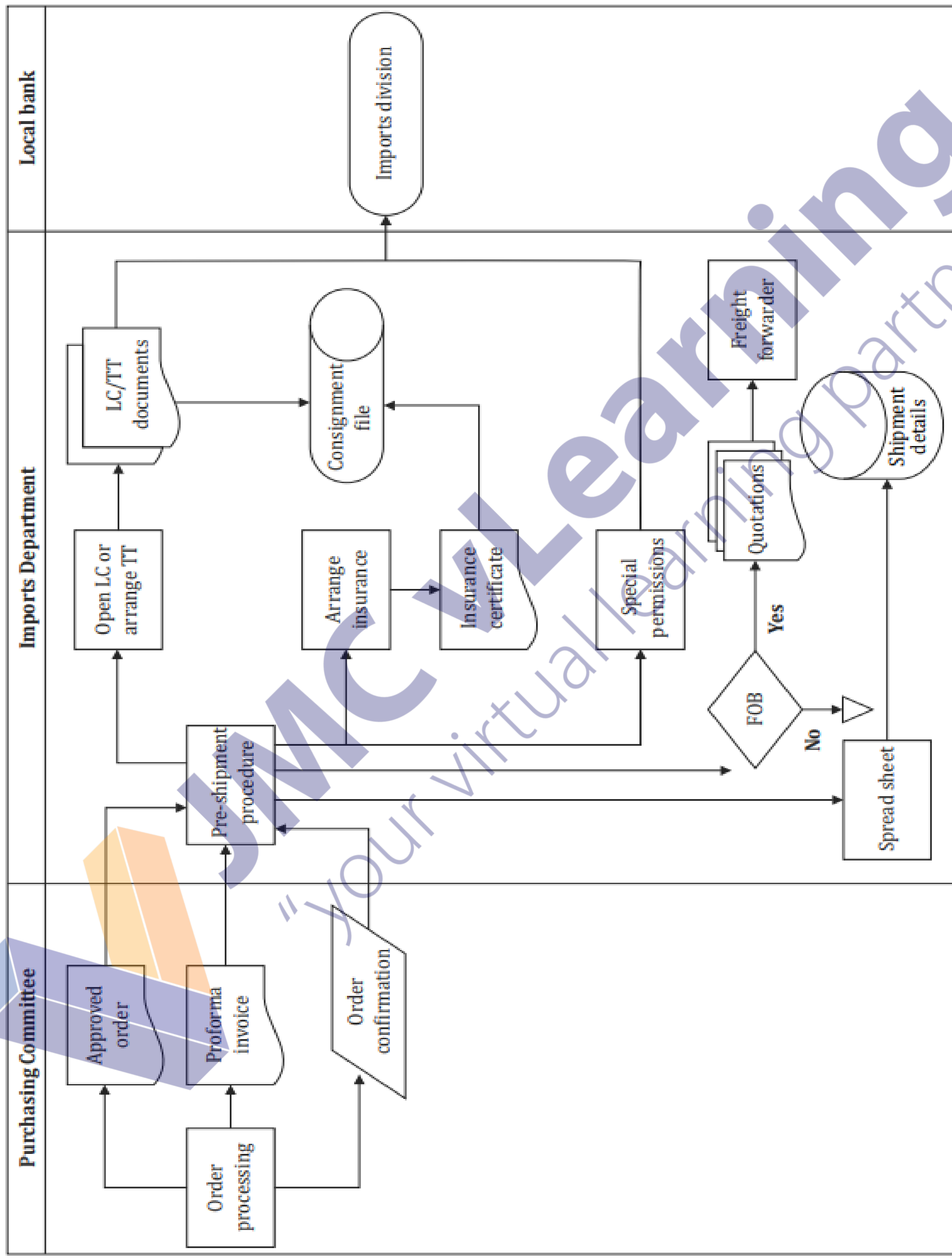
Initiating and placing an order (Imports)



❑ ***Order processing: Imports***

The process is represented in the following diagram

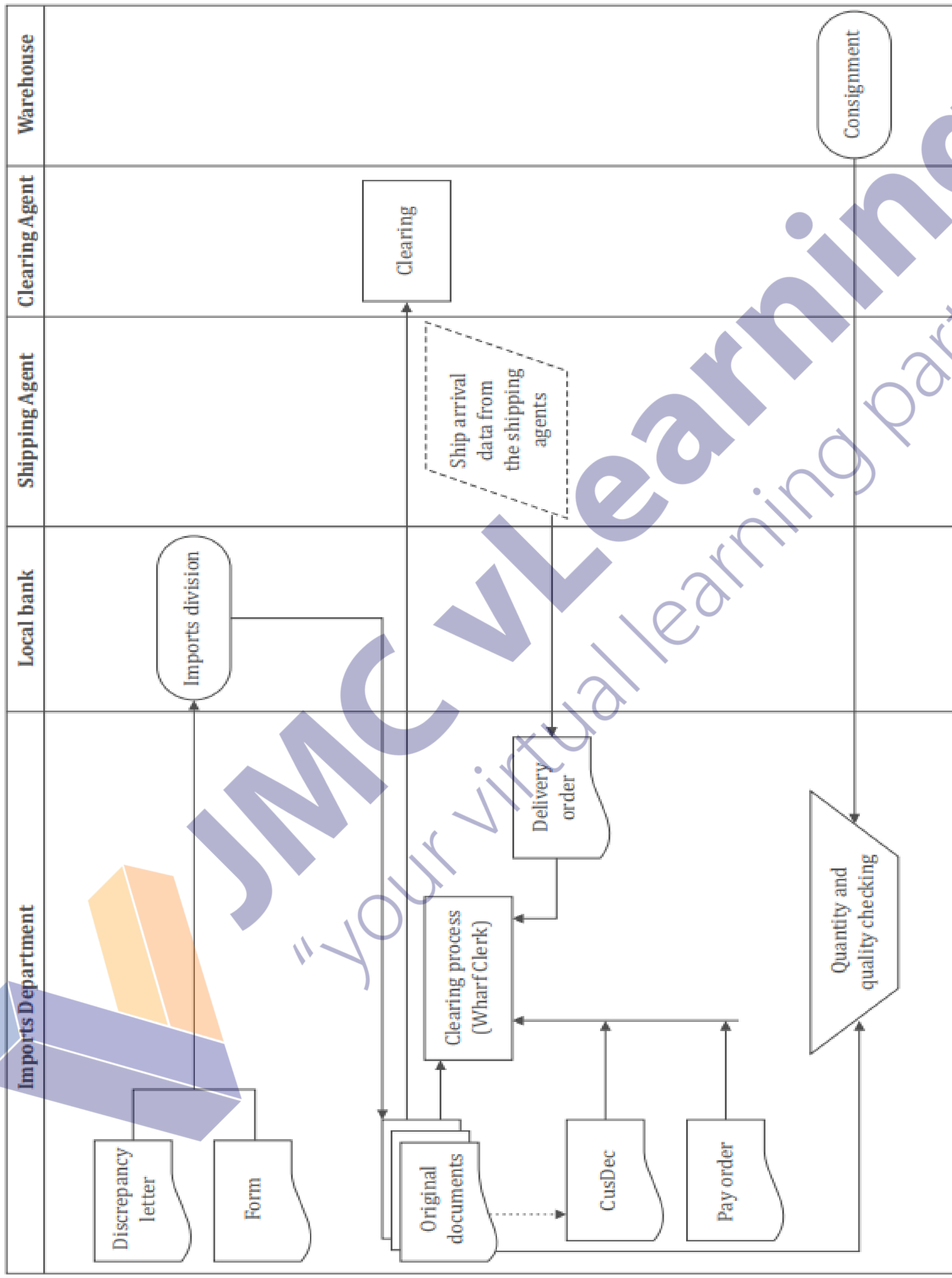
Imports: Order processing and pre-shipment



❑ *Post-shipment procedure*

The process is represented in the following diagram

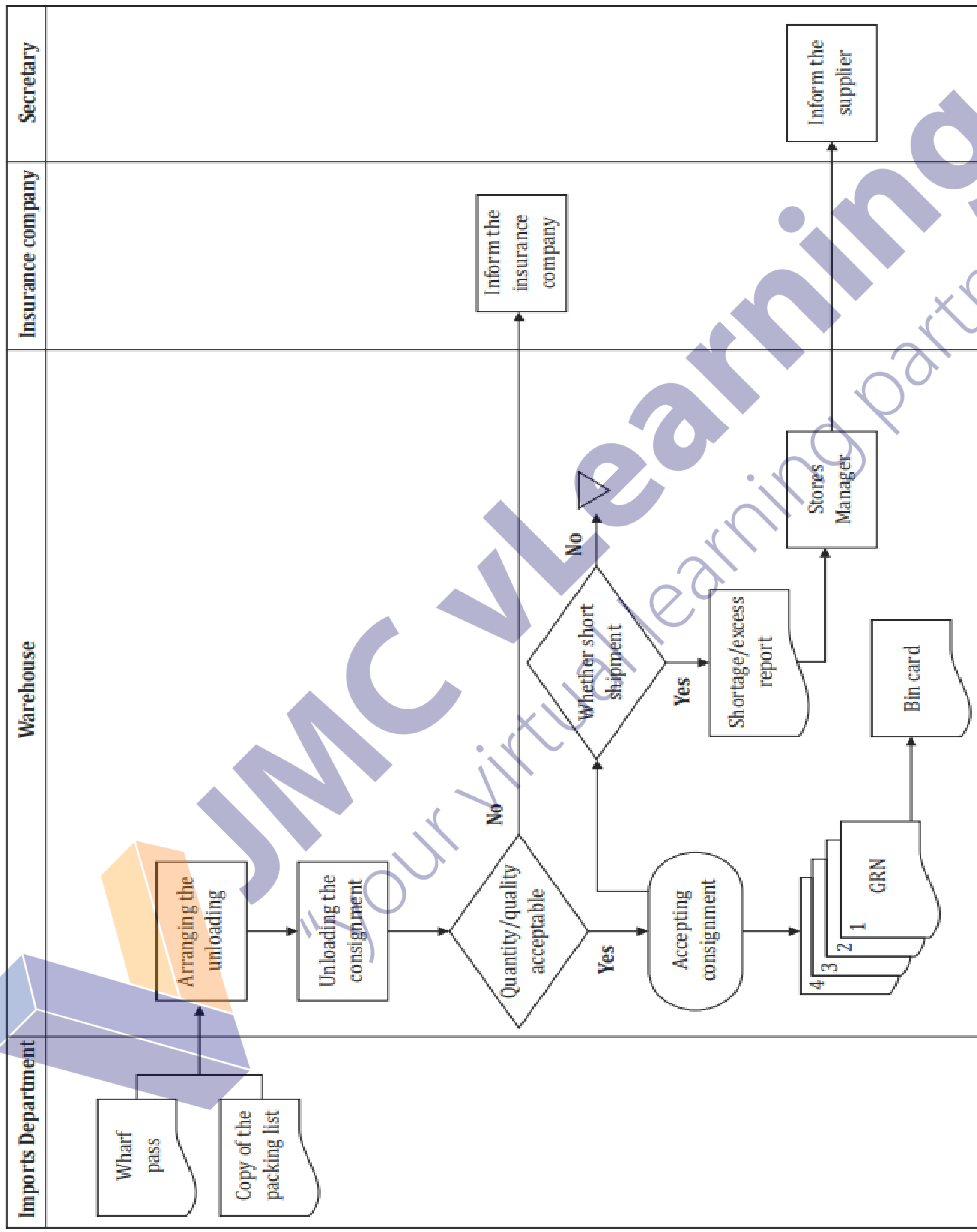
Imports: Post-shipment



❑ ***Inventory receiving: Imports***

The process is represented in the following diagram

Inventory receiving: Imports



B.2.8. Business risks in procurement processes

Organizations should be aware of the business risks in the procurement cycle and should have measures in place to manage these risks. Many of the risks are operational risks, which should be reduced to an acceptable level by means of appropriate internal controls

There are risks in the procurement process that an organization should try to manage. Most of the risks are operational risks, but there may be strategic (external) risks too

Risk	Risk management measure; internal control measure
Supplier is unable to provide the goods, or cannot provide goods to the required quality	Risk should be reduced if a formal selection and evaluation process is used.
Goods are ordered that are not required	Purchase requisitions should be authorised. Purchase requisitions will be checked in the purchasing department and the accounts department. The organisation may use reorder levels and reorder quantities for standard stores items.
Goods are ordered from a non-existent supplier (fraud)	Buyers should use suppliers only if they are on the approved list. There should be controls over updates to the master file containing information about suppliers. User identities and passwords can be used to restrict access, and any changes to the supplier master file should be documented and authorised before the change is made.

Risk	Risk management measure; internal control measure
Goods may be ordered at an excessive price	Specialist buyers may be employed. There may be a fixed price agreement with the supplier for an agreed time period. Management receive regular budgetary control reports.
Goods are not delivered or are delivered in bad condition	Delivery note should be signed only if the goods appear to be in the correct quantity and condition. GRN not completed until goods have been checked in detail for quantity, description and condition (quality). Problems referred to the purchasing department, who should contact the supplier.
Goods discovered to be unusable/unsaleable and are returned are invoiced and paid for	Debit note to be raised to flag that the invoice should not be paid. Payment not to be made where awaiting a credit note for returned goods noted from a review of purchase return documentation.
The supplier submits an invoice for an incorrect amount, or for goods that have not been delivered	Accounts department checks invoice details against purchase order and GRN. Errors are referred back to the supplier.
Supplier invoice is paid even though the invoice details are incorrect (due to fraud or error)	The person making the payment should not be the same as the person authorising payment.

Risk	Risk management measure; internal control measure
The supplier may deliver more goods or less goods than ordered	This problem can be corrected when the goods are discrete items, by returning the excess deliveries or asking the supplier to supply the shortfall when not enough items have been delivered. However, purchased goods are sometimes more difficult to measure – such as grain or rice. For these goods, it may be difficult for the supplier to ensure that an exact quantity of the goods will be supplied. A purchase order may therefore provide for a tolerance level, say of plus or minus 5%. If the goods delivered are within 5% above or below the quantity ordered, this will be considered acceptable. The goods actually received should be measured exactly and this quantity should be confirmed by the person making the delivery. The buyer should be invoiced for the actual amount supplied.

Supplier statement reconciliation

Suppliers may send customers a monthly statement which provides details of:

- The amount owed to the supplier by the customer at the beginning of the month
- Goods supplied and invoiced during the month
- Goods returned to the supplier during the month
- Payments to the supplier during the month
- The amount owed to the supplier by the customer at the end of the month

There should be a reconciliation of suppliers' statements with the buyer's own records to check that there is no discrepancy. If there are any differences, these should be investigated and the reason or reasons identified

Chapter review questions

1. In which order are the following documents produced and used?
   Delivery note; GRN; purchase order; invoice; purchase requisition

2. A purchase order is prepared by a person in the ____________ department and copies are sent to the supplier, the _________________ department and the _____________________ department

3. What internal control should reduce the risk of placing a purchase order with a non-existent supplier?

4. What type of management control may be applied to the cost of procurement of materials?

5. Is the following statement true or false?
   "A delivery note must not be signed by a person in the stores department until the delivered goods have been checked against the details of the purchase order"

6. Before a supplier's invoice is authorized for payment, which three documents should be checked to make sure that their details match? _________________ , ___________________________ and _____________________