

## Task 6 (15 marks)

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You have been provided with the following information about SL Products Ltd's purchasing procedures:

### The Purchasing Manager

Tony Clark, the Purchasing Manager of SL Products Ltd (SLP), is responsible for:

- identifying, approving and liaising with suppliers
- negotiating all contracts and prices with them
- agreeing any price revisions
- agreeing changes in payment terms.

Tony has been in his position for the past six years, but is due to retire in early 20X3. Ruth Holmes, who Tony recruited after joining SLP, assists him. Ruth worked for Tony at a previous company.

Tony uses a small number of suppliers who he has long-standing close relationships with. He believes he gets a better level of service this way, as well as lower prices due to quantity discounts. Normally, he buys at lower than SLP's budgeted standard prices, and regularly has favourable buying variances. Senior management has accordingly given him complete freedom in purchasing arrangements, without involving more senior staff.

### Buying-in prices and terms

Over the past year, the buying-in prices of several components have unusually been well over budget. SLP only calculates a total material price variance each month. As this is always favourable, the adverse variances within it were not apparent.

This only came to SLP's attention via Emily Jones, the Sales Director of Danter Electronics, a supplier to SLP. Emily complained to Shaun Murphy, SLP's Managing Director, that her company had bid an extremely competitive price to supply to SLP but had failed to win the particular contract. She claimed that her tender price was not much greater than marginal cost, and could not understand how the winning supplier, Loebid Ltd, could possibly have undercut her.

Shaun investigated and found that Loebid Ltd had provided the most competitive tender, and so won the contract. However, six months later, Tony Clark had agreed a 15% price increase with them. Tony explained he agreed this because there had been changes in the technical specifications of Loebid Ltd's supplies. Their credit payment terms had also been reduced from 45 to 30 days.

### General procedures

In the past, whenever a new supplier was identified, they were checked for financial stability by Liz Hall, the Accounts Payable Clerk. The procedure was changed last year on Tony Clark's recommendation. Ruth Holmes now runs a check using a large credit reference agency.

Almost all purchases are negotiated to be on 30-day credit terms from end of month of purchase.

When Tony or Ruth raises a purchase order, they immediately enter the details into the company's inventory system. The goods inwards warehouse staff then check that the correct quantities are received in the warehouse. The accompanying goods received notes (GRNs) are checked against the purchase order details on the inventory system. Any discrepancies are noted and investigated by Tony or Ruth.

Suppliers' invoices are sent directly to Ruth. Either she or Tony checks these against the GRNs and the purchase orders. Once invoices are approved they add them to an approved for payment pre-list, on a spreadsheet. This is emailed at the end of each week to Liz Hall, who posts the details into the accounts payable and general ledgers.

Liz produces a monthly aged trade payables listing, identifying suppliers due for payment. Sue Hughes, the Chief Accountant, then reviews the company's cash position and either approves all due payments, or delays some if there is a shortage of cash.

Once Sue has decided upon the final approved payments, Hina Khan, who is in charge of the cash book, produces the Bank Automated Clearing System (BACS) transfer authority and cheques. Around a quarter of SL Products Ltd's suppliers are paid by cheque.

(a) Identify TWO weaknesses in the company's systems, practices and internal controls in respect of each of the following procedures:

(6 marks)

- Purchasing
- Accounts payable
- Internal reporting.

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(b) For each of the three procedures listed above, make a recommendation to improve ONE of the weaknesses you have identified.

(3 marks)

Any improvements involve some financial outlay.

(c) Discuss an analytical method of evaluating whether it would be worthwhile to improve the internal controls in this area.

(6 marks)

## Task 6 (15 marks)

(a) Weaknesses in the company's systems, practices and internal controls

### Purchasing:

1 x mark awarded for reference to any one of the following; **maximum 2 marks**

- There is no effective segregation of duties in the purchasing procedures
- Purchasing Manager is, without any restrictions, able to identify and approve suppliers / negotiate new contracts / agree any subsequent price increases / agree any subsequent changes to payment terms
- Risk that the Purchasing Manager may have developed a relationship that is too close with suppliers / has had a very close working relationship with Ruth Holmes for at least 6 years
- The potential for the Purchasing Department to collude with a supplier (such as Loebid Ltd) to award apparently fair contracts and then subsequently change their terms in return for a bribe.

### Accounts Payable:

1 x mark awarded for reference to any one of the following; **maximum 2 marks**

- The weekly pre-list of approved supplier payments is unnecessary.
- Paying a quarter of suppliers by cheque, rather than by BACS, could be a weakness.
- Cheque processing is costly in terms of both the time involved and bank charges.
- It is also more prone to errors and cheques can be easily lost in the post and possibly misappropriated.
- The pre-list itself, using a spreadsheet, is a possible source of error due to staff making mistakes in entering data.

### Internal Reporting:

1 x mark awarded for reference to any one of the following; **maximum 2 marks**

- The internal reporting of material price variance (MPV) is too limited. It only calculates the total MPV.
- This means that detailed price variances by supplier, and product line are not being reviewed.
- There may well be significant adverse variances that are not being investigated because they are netted off against other favourable variances in arriving at the total MPV. This is the case in this specific task.
- Senior management should review and approve all contracts and orders over a certain value .
- Senior management should also approve any subsequent significant changes in prices or payment terms.
- Someone outside of the Purchasing Department should do the financial stability checks on suppliers
- There should be a defined central policy, probably set by the board, for the criteria to use in selecting suppliers.
- There should be an independent check that purchase prices and goods are as agreed. Tony and Ruth should not be the only individuals checking that invoices are as agreed. Another member of staff (probably the Accounts Payable clerk or Tony's boss) should sample check that the invoiced prices and goods are as agreed. Suppliers' invoices should be sent to the Accounts Payable clerk not the Purchasing Department. They can then be entered onto the system before Tony is asked to approve them. This provides both a more secure audit trail and a better segregation of duties.

### (b) Recommendation to improve one of the weaknesses identified.

**Maximum of 3 marks** to be awarded for reference to any one weakness identified in part (a).

### Purchasing:

- Invoices should be passed for Accounts Payable posting on a daily basis as approved.
- All suppliers should, if possible, be paid by BACS.
- If the company decides to continue using a pre-list it should be derived electronically from the Accounts Payable ledger.
- Price variances should be calculated by: supplier and product line.
- Accounts Department staff should then investigate all significant adverse variances to enable appropriate remedial action to be taken.
- Significant favourable variances should also be investigated so as to further exploit any opportunities this shows up.
- The analytical method of evaluating whether it would be worthwhile to improve the internal controls in this area is a Cost Benefit analysis.
- This examines the costs incurred in making improvements, and the benefits arising from this cost outlay.
- Costs include those for changes to procedures, software, and staff roles and training.
- Benefits include more efficient controls, less risk of errors and reduced risk of fraud.
- Whilst most costs can be quantified the benefits are difficult to measure in monetary terms. However, some attempt should be made to do this.
- For the improvements to be worthwhile the benefits must outweigh the costs.

**Accounts Payable:**

**Internal Reporting:**

**(c) The analytical method of evaluating whether it would be worthwhile to improve the internal controls in this area.**

**Indicative content:**

**0 marks:** No response worthy of credit

**1 – 2 marks:** Limited range of factors discussed. The response will identify the analytical method to use is cost benefit analysis; however, will not be supported by much further reasoning to justify use of method.

**3 – 4 marks:** Range of factors discussed. The response will identify the analytical method to use is cost benefit analysis; which will be supported with some reasoning to justify use of method.

**5 – 6 marks:** Wide range of factors discussed. The response will identify the analytical method to use is cost benefit analysis; and will include sound understanding with supported reasoning to justify use of method.