

THE ANALYSIS OF INTERNAL CONTROLS ON REVENUE AND EXPENDITURE CYCLE IN PT. LEVINA

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ABSTRACT

This research intends to observe and to examine the revenue and expenditure cycle implemented in PT. LEVINA as well to analyze, to assess, and to identify potential weaknesses in the revenue and expenditure cycle, and the internal controls related to those cycles of the company using COSO's Internal Control-Integrated Framework. Moreover, it provides specific recommendations based on the framework to overcome the discovered potential weaknesses.

The method of analysis used in this study is by assessing the current revenue and expenditure cycle implemented in the company, along with the internal controls applied within the cycles. Subsequently, the potential weaknesses will be identified which then generates the specific recommendations. The data-collection methods used are literature and field research.

The current revenue and expenditure cycle of PT. LEVINA are still comprised with potential weaknesses such as structural weaknesses, documentation and business activities (procedures) weaknesses, and Internal Control (IC) weaknesses. Hence, as the company business keeps growing, it is important to focus more on its RC and EC system as well as the IC in order to achieve the most effective and efficient methods in operating the business. As the result, the company could become more profitable.

Keywords: Accounting Information System (AIS), Revenue Cycle (RC), Expenditure Cycle (EC), Internal Control (IC)

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INTRODUCTION

The model corporation analyzed in this study is PT. LEVINA. As one of the major players in the wedding industry in Jakarta that provides catering service and one-stop wedding service, the corporation handles many things to manage and every thing deals with tight-costs. Additionally, it belongs to the small business category, which normally is not very aware of the importance of internal control in operations because small business owners may include a combination of personal preferences, personal financial considerations, and tax considerations as their objectives. For these reasons, this study attempts:

- To observe and to examine the RC and EC implemented in PT. LEVINA, a small business corporation that deals with many business activities regarding wedding events and catering.
- To analyze, to assess, and to identify potential weaknesses in the RC, EC and the IC related to those cycles of PT. LEVINA using COSO's Internal Control-Integrated Framework.
- To provide recommendations regarding the RC, EC, and specifically related IC of PT. LEVINA based on COSO's Internal Control-Integrated Framework that are sound theoretically, practical, and able to solve the potential weaknesses that might be detected in the current system.

THEORITICAL FOUNDATION

➤ Accounting Information System (AIS)

An AIS can be defined as a unified structure within an entity, such as a business firm, that employs physical resources and other components to transform economic data into accounting information, with the (main) purpose of satisfying the information needs of a variety of users (Wilkinson et al. 2000, p. 7). The three specific objectives of AIS that will help to achieve its main purpose are to support the firm's day-to-day operations, to support decision-making process, particularly by internal decision makers, and to fulfill obligations relating to stewardship (Wilkinson et al. 2000, p. 8).

➤ Revenue Cycle (RC)

The RC is a recurring set of business activities and related information processing operations associated with providing goods and services to customers and collecting cash in payment for those sales (Romney & Steinbart 2006, p. 354). The essential purpose of the RC is to provide the right product in the right place at the right time for the right price (Romney and Steinbart 2006, p. 355). The four underlying business activities performed in the RC are *sales order entry*; *shipping*; *billing*; and *cash collections*. Wilkinson et al. (2000, p. 419) summarize the documents pertaining to the RC, which are customer order, sales order, order acknowledgement, picking list, packing slip, bill of lading, shipping notice, sales invoice, remittance advice, deposit slip, back order, credit memo, credit application, salesperson call report, delinquent notice, write-off notice, and cash register receipt.

➤ **Expenditure Cycle (EC)**

Romney and Steinbart (2006, p. 410) define EC as a recurring set of business activities and related data processing operations associated with the purchase of and payment for goods and services. The primary purpose in the EC is to minimize the total cost of acquiring and maintaining inventories, supplies, and the various services the organization needs to function (Romney & Steinbart 2006, p. 410). Moreover, to facilitate the exchange of cash with supplies (vendors) for needs goods (materials) and services (Wilkinson et al. (2000, p. 469). The three underlying business activities in the expenditure cycle are *ordering goods, supplies, and services*; *receiving and storing goods, supplies, and services*; and *paying for goods, supplies, and services*. Wilkinson et al. (2000, p. 472) summarize the documents pertaining to the EC, which are purchase requisition, purchase order, receiving report, supplier's (vendor's) invoice, disbursement voucher, disbursement check, debit memorandum, new supplier (vendor) form, request for proposal (or quotation).

➤ **Internal Control (IC)**

According to Arens, Elder, and Beasley (2003, p. 270), IC can be identified as policies and procedures designed to provide management with reasonable assurance that the company achieves its objectives and goals. Based on Romney and Steinbart (2006, p. 192), the IC performs three different types of controls:

- Preventive Controls, which deter problems before they arise.
- Detective Controls are needed to discover problems as soon as they arise.
- Corrective Controls remedy control problems that have been discovered.

Romney and Steinbart (2006, p. 192) segregate ICs into two categories:

- General Controls: to make sure an organization's control environment is stable and well managed. General Controls regarding the RC and the EC can be categorized into seven different types of controls, and they are *organizational, documentation, asset accountability, management practices, data center operations, authorization, and access controls*.
- Application Controls: to prevent, detect, and correct transaction errors and fraud. These controls on the RC and the EC can be arranged into three major categories, which are the input, processing, and output. Each control would enhance the systems' credibility of a business through its assertions, specifically those related with the RC and the EC. Their amalgamation would result in a fully-integrated and complete application control necessary in managing the RC and the EC.

➤ **COSO's Internal Control-Integrated Framework**

The *Committee of Sponsoring Organizations (COSO)* is a private-sector group consisting of the American Accounting Association, the American Institute of Certified Public Accountants, the Institute of Internal Auditors, the Institute of Management Accountants, and the Financial Executives Institute. In 1992, COSO issued the *Internal Control-Integrated Framework*, which defines internal controls and provides guidance for evaluating and enhancing internal control systems. The report is widely accepted as the authority on internal controls and is incorporated into policies, rules, and regulations that are used to control business activities. COSO's internal control model has five crucial components, which are *control environment, control activities, risk assessment, information and communication, and monitoring* (Romney & Steinbart 2006, p. 195).

The COSO's components used to analyze this study are *control activities, information and communication, and monitoring*.

DATA AND RESEARCH METHODOLOGY

The analysis method for this thesis is by assessing the current RC and EC implemented in the corporation, along with the IC applied within the cycles. Subsequently, the potential weaknesses would be identified and specific recommendations based on COSO's Internal Control-Integrated Framework are generated. There are two (2) sources of data that are being utilized for data-collection of the thesis; the primary and secondary data that support each other.

- The primary data is derived directly from the main source, in this case, the corporation that is being analyzed. This type of data is obtained from the employees of the corporation and direct observations by the author.
- The secondary data is obtained from secondary/other sources, such as textbooks, literatures, published papers/journals, and Internet. This type of data is applied in terms to support the analysis with a theoretical foundation.

The methods of data-collection used by the author are:

- Literature research (theoretical foundation, collecting essential data, printed materials, textbooks, online journals, published papers).
- Field research (doing internship in the corporation to attain the required data, interviews and observations regarding business operations specifically related with RC, EC, and IC implemented within the cycles).

FINDINGS AND DISCUSSIONS

➤ **The Current RC System in PT. LEVINA**

The RC steps and procedures implemented within the company, in general (not specifically).

- 1) Receive customer order via phone, fax, and meeting.
- 2) Inform the customer order to the production regarding the quantities and the due date.
- 3) Ship the ordered goods/services with Sales Order/Packing Slip.
- 4) When the ordered goods/services have been received by the customer, the Sales Order/Packing Slip is stamped and signed by the customer.
- 5) One month later, the goods/services are billed with Sales Invoice (stamp-duty receipt with authorized signature). The customer takes the original invoice while the company gets the copy of invoice and stamped receipt generated by the customer.
- 6) One month afterward, it is the cash collection period. The company makes a call to remind the customer about the due of payment period. Then, the customer make the payment via GIRO cheque/Clearing Deposit Slip or bank (transfer). After that, the company takes the original payment document (receipt) from the customer or just check the bank statements.

- 7) The accounting clerk will record the sales transaction and the amount of sales in the general ledger. She will also keep the RC-related-documents as proofs of the transaction.

➤ **The Current EC System in PT. LEVINA**

The EC steps and procedures implemented within the company, in general (not specifically).

- 1) The President/Owner sets budget.
- 2) The Bill of Materials is created.
- 3) The company compares the price of raw materials/services among the various vendors and contact one of them with the most suitable price by phone or fax.
- 4) When the goods are arrived in the production place (warehouse), the quantity and the quality are checked to ensure that it is match with the Bill of Materials. After it is confirmed, then the Vendor's Invoice (no Packing Slip from vendor, so the goods are delivered with the invoice) is signed and the copy is taken and kept.
- 5) One until two weeks afterward, the company confirms and pays for the purchases/expenses via bank (transfer) and the company keeps the original receipt.
- 6) The accounting clerk will record the purchase transaction and the amounts of obligation paid in the general ledger. She will also keep the EC-related-documents as proofs of the transaction.

➤ **Potential Weaknesses**

Structural Weaknesses

- The RC System: The Accounting Clerk (AC) performs most of the RC activities and is given too much responsibility over business, specifically RC, transactions or processes. She is the one, who receives and approves the customer order, prepares the RC source documents i.e. Sales Order/Packing Slip, yet she also maintains the General Ledger and bills the customer. This is the situation where fraudulent deeds might be occurred. For examples, the AC might have conflict of interest with the customer and cheat the President/Owner; she also might charge the customer with higher price, but record and report the transaction using the normal price.
- The EC System: The company combines the authorization, recording and custody functions under one department; the Receiving, Purchasing and Inventory Control (R, P & IC). This is a breach in term of segregation of duties. The R, P & IC staff does most of the EC activities and is given too much responsibility over business, specifically EC, transactions or processes. She is the one, who makes the orders, receives the ordered goods, controls and records the inventory, and posts the Accounts Payable Data Store. This is the situation where fraudulent acts might be occurred. For examples, the R, P & IC staff might have conflict of interest with the vendor and cheat the President/Owner; she might also steal the unrecorded inventory (other than frozen food) and no one will take notice.

Documentation and Business Activities (Procedures) Weaknesses

The potential documentation and business activities (procedures) weaknesses in PT. LEVINA's RC system are:

- o The RC documents are not well pre-numbered i.e. inconsistent in numbering the documents. There will be difficulties in generating and analyzing the

output/reports, particularly when the company starts using computerized accounting system.

- o During sales order entry activity, the Accounting Clerk directly approves the order without checking the customer credit records (customer control account or Accounts Receivable Data Store). There is a possibility that the customer has yet not paid a great amount of obligation towards the company.
- o During shipping activity, the Shipping staff directly takes and ships the ordered goods without signing any document to verify these activities. Moreover, it is inappropriate to give all the Sales Order/Packing Slip (SO/PS) documents to the Shipping staff during delivery, especially the original document. It is quite risky because the Shipping staff might lose it. Furthermore, the original document should not be given to the customer, but the Accounting Clerk of the company.

The possible documentation and business activities (procedures) weaknesses in PT. LEVINA's EC system are:

- o During ordering activity:
 - ✓ The order (purchase) is made based on the Bill of Material (BOM) rather than a formal purchase order. Moreover, the order is arranged via phone and no formal document about the purchase that is sent to the customer for approval and acknowledgement. Hence, the transaction is not fundamentally bonded.
 - ✓ The Bill of Material (BOM) document is banished when the EC is completed, whereas it is essential for documentation and audit purposes.
- o During receiving and storing activity, the R, P & IC staff does not record the goods received nor creates receiving report. No specific and well-designed shipping documents, currently it uses the sales order that also acts as packing slip.
- o The EC documents are not well pre-numbered i.e. inconsistent in numbering the documents. There will be difficulties in generating and analyzing the output/reports, particularly when the company starts using computerized accounting system.

Internal Control (IC) Weaknesses

The possible weaknesses in the general control of the company's RC system are:

- o Organizational Controls
 - ✓ The Accounting Clerk has many responsibilities that in fact should be separated from each other such as billing, accounts receivable, general ledger, and data processing. This could create conflict of interest issue between the AC and the customer. The President/Owner also does not really check the documents supporting the transaction.
- o Documentation Controls
 - ✓ The RC documentation is not complete:
 - More copies of Customer Order (CO) documents needed because one is inadequate. If the Accounting Clerk only informs the CO information by phone, there is a possibility that the Operations Manager jots down the incorrect information, which might lead to misunderstanding.

- For via phone order, there are no original-documented CO from the customer and documented Order Acknowledgement (OA), thus the transaction has no strong binding and lack of evidence.
 - o Asset Accountability Controls
 - ✓ The Shipping staff delivers the ordered (produced) goods from the warehouse/production place when the AC or the President/Owner gives verbal order, however no written proof (document) to be signed by the Shipping staff during this activity. This is risky since there is a possibility that he would steal the goods but no evidence exists.
 - o Management Practices Controls
 - ✓ No written management policies concerning the RC such as credit approvals, account write-offs, and sales and cash receipts procedures; this could cause troubles as the company keeps growing and starts to employ more people to handle the RC activities. With the absence of written procedures, the RC processes might be done under ambiguity and discrepancy. Moreover, if the Accounting Clerk resigns, the company will be troubled to train the new employee who is replacing her position.
- The possible weaknesses in the general control of the company's EC system are:
- o Organizational Controls
 - ✓ The Receiving, Purchasing, and Inventory Control staff has many responsibilities, which should be separated from each other such as recording inventory control, accounts payable, and data processing. Most of the EC processes are done by the R, P & IC staff. This could create conflict of interest issue.
 - o Documentation Controls
 - ✓ The EC documentation is not complete since no formal documentation of:
 - Purchase requisition, which indicates that there is lack of authorization in term of order placement.
 - Purchase order, which shows that there is no strong binding for the transaction.
 - Receiving report. This is necessary for inventory reconciliation and further inspection.
 - o Asset Accountability Controls
 - ✓ The acknowledgement method for receipt of delivered goods is inappropriate; no receiving report made and signed by the Receiving, Purchasing & Inventory Control department. The Vendor Invoice's copy is the only document that acts as proof of receiving the delivered goods. In case the VI's copy is lost, there is no other proper document to trace the receipt of ordered goods.
 - ✓ The R, P & IC staff is the one who initiates the (purchase) order, receives the delivered goods, and monitors the inventory, but she also the one who logs all incoming invoices from vendors and compares the invoices with supporting documents which raise issues on accountability.
 - o Management Practices Controls.
 - ✓ No written management policies concerning purchase discounts, purchase returns, and purchases and cash disbursements procedures; this could cause problems as the company keeps growing and starts to employ more people

to handle the EC activities. With the absence of written procedures, the EC processes might be done under ambiguity and discrepancy. Furthermore, if the R, P & IC staff resigns, it will be a drawback for the company to train the new employee who is replacing her position.

- o Authorization Controls
 - ✓ All purchases transactions for goods or services should be authorized by designated managers, normally the inventory or department manager, however the company directly gives the authority to the R, P & IC staff, not the Operations Manager.
 - ✓ No appropriate documents i.e. the purchase requisitions, purchase orders, and receiving reports that formally authorize the acquisition of goods and receiving.

➤ **Specific Recommendations**

Recommended Organizational Structure

- ✓ The Accounting Clerk should not perform the billing activity and there should be another person who is in charge for that activity. At least, if there are two people who are responsible for the RC processes that handle different kind of activities, it would minimize the possibility of fraud since the portion of responsibilities and authorizations would be lesser and limited for each individual. Since the Accounting Manager is only a part-time employee, the company needs to hire another person in the Accounting Division as the Billing staff.
- ✓ The receiving function should be separated from purchasing and inventory control function to reduce the opportunity of employee theft i.e. unauthorized consumption of food or stealing the inventory. Therefore, there should be one additional staff to perform receiving activity and one staff to do purchasing and inventory control activities, in order to avoid too much authorizations and responsibilities over inventory.

These organizational structure's recommendations are aligned with the Control Activities component of COSO's internal control model.

Recommended Documentation and Business Activities (Procedures)

For the RC system:

- o There should be an original documented Customer Order made by the customers.
 - ✓ They can send it via fax or mail.
 - ✓ The document must be signed (authorized) by the customer.
 - ✓ It is recommended that PT. LEVINA creates an email, so the customers can make the order via the Internet.
 - ✓ After the Accounting Clerk has received the documented Customer Order, she will copy the document and fax it to the production place (warehouse). The Operations Manager who is in charged of the production place will acknowledge the Customer Order by signing it and fax it back to the Accounting Clerk.
- o Before the shipment, there should be a document that acts as proof or receipt that the Shipping staff has taken the goods, which are to be delivered

and verifies the shipping activity. It should contain information such as the date of shipment (usually the date when the goods are transferred to the Shipping staff), the type and quantity of the goods that are to be shipped to the customer, and the names of those who transfer (the Production Supervisor) and receive (the Shipping staff) the goods along with their signatures. This document could be called as Transfer of Goods Proof (one original document that is kept by the Purchasing and Inventory Control staff and one copy, which is kept by the Shipping staff).

- o There should be one original document and three copies of Sales Order/Packing Slip.
 - ✓ During the delivery, the Shipping staff will take one original and two copies of the document from the Production Supervisor. The other one copy is kept by the Accounting Clerk as proof of transaction and backup document.
 - ✓ When the customer has received the goods, he/she will sign or stamp the document.
 - ✓ After that, the Shipping staff will only give the one signed-copy document to the customer and take back the stamped/signed original Sales Order/Packing Slip (one) and its other copy (one), which are sent to the Billing staff.
- o As for the Order Acknowledgement, for via mail order, the Accounting Clerk will mail back the authorized Order Acknowledgment memo.
- o All the RC documents, which are Customer Order, Transfer of Goods Proof, Order Acknowledgement, Sales Order/Packing Slip, Sales Invoice, authorized receipt from the customer, customer's Deposit Slip and GIRO Cheque/Clearing Deposit Slip should be consistently pre-numbered and synchronized in order to make the verifying process much easier. Additionally, this is very useful for audit purposes in term of validity, existence, and completeness. Moreover, when the company wants to apply computerized accounting system, this will decrease the workloads that are necessary to be done since the data is already well-organized.
- o It will be better to take a proactive approach and establish credit limits for the customers to minimize the risk of bad debts due to the increase in business volume.

For the EC system:

- ✓ It is highly recommended for the company to add Purchase Requisition, Purchase Order, and Receiving Report documents in its EC system.
 - o In order to avoid inefficiency (purchasing the wrong types and amount of goods required for the production); the Purchasing & Inventory Control staff should create a Purchase Requisition document, instead of Bill of Materials, which requires to be reviewed and authorized by the Operations Manager. There should be one original document to be kept by the Operations Manager and one copy for the Purchasing & Inventory Control staff as proof that the order has been approved. This document should identify the requisitioner (with signature as well), chosen vendor, date needed, reason of requisition, identify the item descriptions, quantity,

and price of each item requested along with the total, state the person who authorizes it, and date of approval.

- Afterward, the Purchasing & Inventory Control staff should generate a formal Purchase Order based on the approved Purchase Requisition. The purpose of this document is to officially bind the vendor regarding his/her obligation towards the company and vice versa. There should be one original Purchase Order that has been authorized by the Purchasing & Inventory Control staff, which is faxed to the vendor. As for the acknowledgement, the vendor will fax back the Purchase Order and signed on it as well. The document should include the name of vendor, the order and requested delivery dates, the delivery location (PT. LEVINA's production place), information about the items ordered, Purchase Requisition number, terms of payment and signatures of the Purchasing & Inventory Control staff and vendor.
- The Bill of Material document is not recommended to be used. However, if it is still wanted to be used, then it is not supposed to be thrown away at the end of the EC system, but it must be kept for audit and documentation purposes as supporting document.
- Receiving Report is a very important document in the EC system during the receiving activity. It can be used to verify the effectiveness of the activity and the accuracy of the information, to further reconcile and inspect the inventory. This document should identify details about each delivery, including the date received, shipper, vendor, and Purchase Order number. For each item received, it should show the item description, unit of measurement, and quantity. In addition, it should state who received and inspected the goods as well as allow for comments concerning the quality of the items received. The Receiving staff should generate one original and two copies of this document during receiving the ordered goods and Vendor's Invoice (note: the vendor delivers the goods with the Vendor's Invoice; not Packing Slip due to the lack of financial sophistication from vendor's point of view). The original document is kept by the Receiving staff for documentation, one copy is transferred to the Accounting Clerk for payments of goods process and the other copy is kept by the Purchasing and Inventory Control staff to close the order.
- ✓ All the EC documents, which are the Purchase Requisition, Purchase Order, Receiving Report, Vendor's Invoices, and Receipt (proof of payment) should be well pre-numbered and synchronized in order to make the verifying process less complicated. Moreover, this is very useful for audit purposes in term of validity, existence, and completeness. In addition, when the company wants to apply computerized accounting system, this will decrease the workloads that are necessary to be done since the data is already well-organized.

These documentation and business activities' recommendations are aligned with the Control Activities as well as the Information and Communication components of COSO's internal control model.

Recommended Internal Control

For the RC system:

- o There should be written management policies concerning the RC such as credit approvals, account write-offs, and sales and cash receipts procedures.
- o There should be audits performed in regard with the sales and cash receipts procedures and policies (if they have already been established).
- o The transaction listings i.e. cash receipt journal and account summaries should be prepared on a periodic basis in order to provide audit trail and a basis for review.

For the EC system:

- o There should be written management policies concerning purchase discounts, purchase returns, and purchases and cash disbursements procedures.
- o There should be audits performed on the purchases and cash disbursement procedures and policies (if they have already been established).
- o Managers should review periodic analyses, control summaries, and reports concerning account activity.
- o Audits like inventory surprise counts should be performed in order to safeguard the inventory and prevent employee theft.

These internal controls' recommendations are aligned with the Control Activities and the Monitoring components of COSO's internal control model.

CONCLUDING REMARKS

➤ Conclusion

The current RC and EC system of PT. LEVINA are still comprised with potential weaknesses such as:

- o **Structural weaknesses**
The Accounting Clerk (the RC system) and the Receiving, Purchasing & Inventory Control staff (the EC system) performs most of the activities and are given too many responsibilities over business transactions or processes. Noticeably, there is segregation of duties flaws within the company.
- o **Documentation and business activities (procedures) weaknesses**
In the RC system, the possible weaknesses found are documents that are not well pre-numbered, the Accounting Clerk does not check the customer credit records during sales order entry activity, no document to verify the transfer of goods to the Shipping staff, and all the Sales Order/Packing Slip documents (including the original) are transferred to the Shipping staff for delivery. As for the EC system, the potential weaknesses are the order (purchase) is made based on the Bill of Materials that is banished when the EC is completed; rather than a formal Purchase Order, no Receiving Report during receiving and storing activity, and the EC documents are not well pre-numbered.
- o **Internal Control (IC) weaknesses**
The potential weaknesses identified in the RC system are segregation of duties flaws regarding the Accounting Clerk, incompleteness of RC documentation (the Customer Order document), no written proof (document) to be signed by the Shipping staff to deliver the goods, and no written management policies concerning

the RC. As for the EC system, the possible weaknesses are segregation of duties of the Receiving, Purchasing & Inventory Control staff, incompleteness of EC documentation (Purchase Requisition, Purchase Order, Receiving Report), the inappropriate acknowledgement method for receipt of delivered goods, no written management policies concerning the EC, and authorization issues.

Currently, the company is doing all right and keeps growing; however with the potential weaknesses identified in the study, which are mainly about segregation of duties and lack of documentation, there is a possibility that the company does not operate in the most effective, efficient, and profitable ways.

➤ **Overall Recommendations**

The company should enhance its documentation in order to have a better control and reliability over business transactions. Likewise, an appropriate segregation of duties should be implemented within the company to minimize the possibility of fraud and employee theft. It is also encouraged to conduct audits. In addition, PT. LEVINA might implement the specific recommendations, which are based on COSO's Internal Control-Integrated Framework, made by the author.

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