

Ch10 Cash and Financial Investments

Chapter Opener

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Learning objectives

After studying this chapter, you should be able to:

LO1

LO2 Identify the auditors' objectives in the audit of cash.

LO3 Explain the nature of the cash receipts and disbursements over the business processes related to cash.

LO4 Use the understanding of the client and its environment to identify risks related to cash.

LO5 Obtain an understanding of internal control over cash.

LO6 Assess the risks of material misstatement of cash and design controls and substantive procedures, to address the risks.

LO7 Describe the risks involved in auditing financial investments and the specialized skills.

LO8 Identify the auditors' objectives in the audit of financial investments.

LO9 Describe typical internal controls over the business processes related to cash.

LO10 Describe tests of controls and substantive procedures used to audit cash.

This chapter describes the approach to the audit of cash and financial investments. Our discussion of these two types of assets is combined because of the interrelationship between them. Cash and many financial investments are liquid in nature, and transfers between the two accounts occur frequently.

Cash

Sources and Nature of Cash

Cash normally includes general, payroll, petty cash, and, less frequently, savings accounts. General accounts are checking accounts similar in nature to those maintained by individuals. Cash sales, collections of receivables, and investment of additional capital typically increase the account; business expenditures

LO1

Describe the sources and nature of cash.

decrease it. Under the terms of a bank loan agreement, the cash in a company's general account sometimes must be maintained at a specified minimum balance, referred to as a *compensating balance*.

Payroll and petty cash accounts are “imprest” at a low balance. When payroll is paid, a transfer is made from the general account to the payroll account. Petty cash, used for very small expenditures, is replenished as necessary.

Cash equivalents are often combined with cash items to create the current asset classification called “cash and cash equivalents.” *Cash equivalents* include money market funds, certificates of deposit, savings certificates, and other similar types of deposits. Any item that cannot be converted to cash on short notice should be classified as an investment, a receivable, or a prepaid expense, rather than as a cash equivalent.

Normal internal control activities (e.g., reconciliation of bank accounts) detect most errors that occur in these accounts. On the other hand, the liquid nature of cash increases the risk of fraud, which may be more difficult to detect.

The Auditors' Objectives in the Audit of Cash

The auditors' *objectives* in the audit of cash and cash transactions are to:

1. Use the understanding of the client and its environment to consider *risks*, including fraud risks, related to cash.
2. Obtain an understanding of *internal control*

LO2

Identify the auditors' objectives in the audit of cash.

3.

Assess the risks of material misstatement of cash and design tests of controls and substantive procedures that:

a.

b. Determine the accuracy of cash transactions.

c. Establish the *completeness* of recorded cash transactions.

d. Verify the *cutoff* of cash transactions.

e. Determine that the client has *rights* to recorded cash.

f. Determine that the *presentation* and classification (e.g., cash and cash equivalents, balances and bond sinking funds), are appropriate.

reconciling underlying records to the general ledger results and, if appropriate, proper valuation of foreign currency translation. We omit a separate valuation objective in the above list due to the ordinarily very limited valuation issues relating to cash (e.g., there is no need to consider valuation issues such as *net realizable value*, as with receivables, or the *lower of cost or market*, as with inventories).

How Much Audit Time for Cash?

The consideration of materiality applies to audit work on cash as well as to other aspects of the audit. The counting of a small petty cash fund, which is inconsequential in relation to the company's overall financial position, accomplishes little in achieving the auditors' objective of expressing an opinion on the financial statements. Nevertheless, auditors do devote a larger proportion of the total audit hours to cash than might be suggested by the relatively small amount of cash shown on the balance sheet.

Several reasons exist to explain the auditors' traditional emphasis on cash transactions. Liabilities, revenue, expenses, and most other assets flow through the Cash account; that is, these items either arise from or result in cash transactions. Thus, the examination of cash transactions assists the auditors in the substantiation of many other items in the financial statements.

Another reason contributing to extensive auditing of cash is that cash is the most liquid of assets and offers the greatest temptation for theft, embezzlement, and misappropriation. Inherent risk is high for liquid assets, and auditors tend to respond to high-risk situations with more intensive investigation. However, the detection of fraud is relevant to the overall fairness of the client's financial statements only if such fraud is material in amount.



On occasion, auditors may encounter evidence of small-scale employee fraud. After determining that such fraud could *not* have a material effect upon the financial statements, the auditors should review the situation with the management and the audit committee of the board of directors before investigating the matter further. This discussion will alert the client to the situation, protect the auditors from charges of negligence, and avoid wasting audit time on matters that are not material to the financial statements and that may better be pursued by client personnel.

Internal Control over Cash Transactions

Most of the processes relating to cash handling are the responsibility of the finance department, under the direction of the treasurer. These processes include handling and depositing cash receipts; signing checks; investing idle cash; and maintaining custody of cash, marketable securities, and other negotiable assets. In addition, the finance department must forecast cash requirements and make both short-term and long-term financing arrangements.

Ideally, the functions of the finance department and the accounting department should be integrated in a manner that provides assurance that:

LO3

Explain the nature of the cash receipts and disbursements cycles, and describe the fundamental controls over the business processes related to cash.

1. All cash that should have been received *was* in fact received, recorded accurately, and deposited promptly.
2. Cash disbursements have been made for authorized purposes only and have been properly recorded.
3. Cash balances are maintained at adequate, but not excessive, levels by forecasting expected cash receipts and payments related to normal operations. The need for obtaining loans or for investing excess cash is thus made known on a timely basis.

A detailed study of the business processes of the client is necessary in developing the most efficient control procedures, but there are some general guidelines to good cash-handling practices in all types of business. These guidelines for achieving internal control over cash may be summarized as follows:

1. Do not permit any one employee to handle a transaction from beginning to end.

2. Separate cash handling (custody) from record keeping.

- p. Centralize receiving of cash to the extent practical.

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- 3.

4. Record cash receipts on a timely basis.

5. Encourage customers to obtain receipts and observe cash register totals.

6. Deposit cash receipts daily.

7. Make all disbursements by check or electronic funds transfer, with the exception of small expenditures from petty cash.

8. Have monthly bank reconciliations prepared by employees not responsible for making cash payments or custody of cash. The completed reconciliation should be reviewed promptly by an appropriate official.

9. Monitor cash receipts and disbursements by comparing recorded amounts to forecasted amounts and investigating variances from forecasted amounts.

Internal Control over Cash Receipts

Cash Sales

Control over cash sales is strongest when two or more employees (usually a salesclerk and a cashier) participate in each transaction with a customer. Restaurants and cafeterias often use a centrally located cashier who receives cash from the customer along with a sales ticket prepared by another employee. Theaters generally have a cashier selling prenumbered tickets, which are collected by a door attendant when the customer is admitted. If tickets or sales checks are serially numbered and all numbers accounted for, this separation of responsibility for the transaction is an effective means of preventing fraud.

In many retail establishments, the nature of the business is such that one employee must make over-the-counter sales, deliver the merchandise, receive cash, and record the transaction. In this situation, dishonesty may be discouraged by proper use of cash registers or electronic point-of-sale systems. The protective features of cash registers include (1) visual display of the amount of the sale in full view of the customer; (2) a printed receipt, which the customer is urged to take with the merchandise; and (3) accumulation of the total of the day's sales.

Electronic Point-of-Sale Systems

Many retail stores use various types of electronic cash registers, including online computer terminals. Often, an

electronic scanner reads the *universal product code* on the product. The salesperson need only scan the code for the register to record the sale at the product's price, which is stored in the computer. Thus, the risk of a salesperson recording sales at erroneous prices is substantially reduced.

Besides providing strong control over cash sales, electronic point-of-sale systems often may be programmed to perform numerous other control functions. For example, online registers may verify the credit status of charge account customers, update accounts receivable and perpetual inventory records, and provide special printouts accumulating sales data by product line, salesperson, department, and type of sale.

Collections from Credit Customers

In many manufacturing and wholesale companies, cash receipts include checks received through the mail. This situation poses little threat of defalcation unless one employee is permitted to receive and deposit these checks and also to record the credits to the customers' accounts. Typical internal control over cash received through the mail is described below.

Incoming mail usually is opened in the mailroom, where an employee endorses the checks "for deposit only" to the company's account and prepares a *control listing* of the incoming cash receipts. This listing shows the amount received from each customer and identifies the customer by name or account number. A copy of the control listing is forwarded to the controller. Another copy of the control listing and the cash receipts are forwarded to the cashier. The remittance advices and a copy of the control listing (shown below) are forwarded to the employee responsible for the customers' accounts.

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Check (and remittance advice)

Pilot Stores 1425 G St. Irvine, CA 92345	987604 Date: Dec. 5, 20XX
Pay to the order of <u>Wood Supply Co.</u>	\$8085.00
Eight thousand eighty-five and no/100	
First National Bank California	Pilot Stores <i>Jackie Cohen</i>
Remittance Advice	
Wood Supply Co. Inv. #7462537	\$8085.00

CONTROL LISTING		
Payer	Cust. No.	Amount
XXXXXXXXXX	#####	\$\$\$\$\$.55
XXXXXXXXXX	#####	\$\$\$\$\$.55
XXXXXXXXXX	#####	\$\$\$\$\$.55
Pilot Stores	12654	\$8085.00
XXXXXXXXXX	#####	\$\$\$\$\$.55
XXXXXXXXXX	#####	\$\$\$\$\$.55
		\$\$\$\$\$.55

Which controls tend to prevent the mailroom employee from abstracting the receipts from several customers, destroying the remittance advices, and omitting these receipts from the control listing? First, incoming cash receipts consist primarily of checks made payable to the company. Second, if customers' accounts are not credited for payments made, the customers will complain to the company. If these customers can produce paid checks (or electronic check copies) supporting their claims of payment and these checks do not appear on the mailroom control listings, responsibility for the abstraction is quickly focused upon the mailroom employee.

The checks are transferred to the cashier (with a copy of the control listing), who deposits the day's receipts intact in the bank. Control is exercised over the cashier by periodic reconciliation of the operations control copies of the mailroom control listings with the cash receipts journal and the details of the validated deposit slips received from the bank.

Direct Receipt of Funds by Financial Institutions

Sales proceeds are often received directly by the clients' financial institution, which then notifies the business of the receipt through a variety of manners, including lockbox systems, credit cards, debit cards, and electronic transfer of funds by customers.

Businesses receiving a large volume of cash through the mail may use a lockbox system to strengthen internal control and hasten the depositing of cash receipts. The **lockbox** *A post office box controlled by a company's bank at which cash remittances from customers are received. The bank picks up the remittances, immediately credits the cash to the company's bank account, and forwards the remittance advices to the company.* is actually a post office box controlled by

the company's financial institution. Financial institution employees pick up mail at the post office box several times a day, credits the company's checking account for cash received, and sends the remittance advices to the company. Internal control is strengthened by the fact that the financial institution has no access to the company's accounting records.

Proceeds from credit card and debit card sales are handled in a similar manner by the bank(s) involved with the process. Ultimately, proceeds are deposited into the business's cash account.

Electronic Funds Transfer

Electronic funds transfer (EFT) systems*A computer system that transmits and processes funds-related cash disbursement and receipt transactions. Increasingly, companies are electronically transferring funds between bank accounts rather than issuing checks. See also electronic data interchange.* process funds-related transactions for customers as an alternative to paying by check. Increasingly, **electronic data interchange (EDI)***A computer network between companies that allows the interchange of data from one company's computer to the other's (e.g., allows purchases and sales between two firms to be processed electronically).* systems, which allow the interchange of data from one company's computer to another's, are electronically transferring funds between companies' bank accounts. These systems reduce paper flow and may reduce processing costs and delays. They do, however, require an extensive set of computer network controls relating to system access and data entry, as well as backup controls for situations in which a system breakdown occurs.

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Recording Cash Receipts

The employee responsible for the customers' accounts ledger enters the details of cash receipts into the computer in batches. The cash receipts program creates a file of cash receipt transactions that is used to update the general ledger and the master file of accounts receivable. This computer program creates control totals and exception reports that detail any invalid customer account numbers or unusual payment amounts. The manual follow-up procedures on exceptions reports and the reconciliations of control totals are performed by the operations control group.

The division of responsibilities, sequence of procedures, and controls over cash sales and collections from customers are illustrated in the systems flowchart in [Figure 10.1](#).

Internal Control over Cash Disbursements

Ideally, cash disbursements should be made by check, electronic funds transfer, or, for minor items, from petty cash funds.

Checking Account Disbursements

A principal advantage of requiring disbursement by check is obtaining evidence of receipt from the payee in the form of an endorsement on the check. Other advantages include (1) the centralization of disbursement authority in the hands of a few designated officials—only persons authorized to sign checks; (2) a permanent record of disbursements; and (3) a reduction in the amount of cash kept on hand.

To secure in full the internal control benefits implicit in the use of checks, it is essential that all checks be prenumbered and all numbers in the series be accounted for. Unissued prenumbered checks should be adequately safeguarded against theft or misuse. Voided checks should be defaced to eliminate any possibility of further use and filed in the regular sequence of paid checks. Dollar amounts should be printed on all checks by the computer or a check-protecting machine. This practice makes it difficult for anyone to alter a check by raising its amount.

Officials authorized to sign checks should review the documents supporting the payment and perforate (deface) these documents at the time of signing the check to prevent them from being submitted a second time. The official signing checks should maintain control of the checks until they are placed in the mail. Typically, the check comes to the official complete except for signature. To make a variety of fraudulent schemes involving falsified documents less likely, the signed checks should not be returned to the accounting department, which prepared them for signature.

Most companies issuing a large volume of checks use computers or check-signing machines. The authorized signature (usually that of the treasurer) may be printed automatically on each check as it is processed. If the computer generates signed checks, item counts, control totals, and cash totals (reconciled by finance department personnel) may

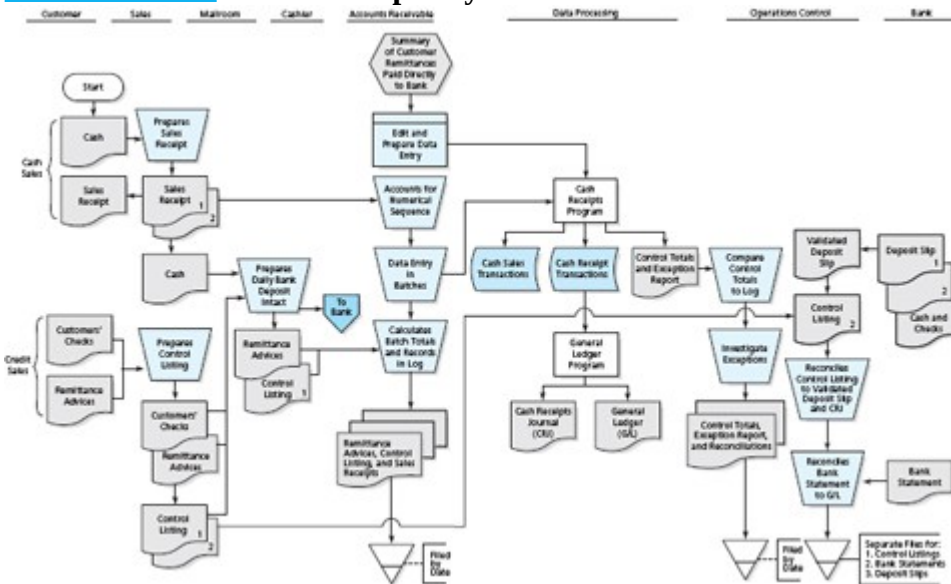
be used to make certain that checks are issued only for authorized cash disbursements. When a check-signing machine is used, the machine should be safeguarded with physical locks and keys and/or passwords. Additional controls may be established for large checks, such as the requirement for a second manual signature.

Reconciliation of monthly bank statements is essential to adequate internal control over cash receipts and disbursements. An employee having no part in authorizing or accounting for cash transactions or in handling cash should reconcile bank statements. Statements from the bank should come unopened to this employee. Each month the completed bank reconciliation should be reviewed by a responsible company official and approved in writing.

A voucher system is one method of achieving strong internal control over cash disbursements by providing assurance that all disbursements are properly authorized and reviewed before a check is issued. In a typical voucher system, the accounting department is responsible for assembling the appropriate documentation to support every cash disbursement. For example, before authorizing payment for merchandise purchased, the accounting department assembles copies of the purchase order, receiving report, and vendor's invoice and determines that these documents are in agreement. After determining that the transaction is properly supported, an accounting employee prepares a voucher, which is filed in a tickler file according to the date upon which payment will be made.

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FIGURE 10.1 Cash Receipts Cycle



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A voucher is a document authorizing a cash disbursement. A voucher usually provides space for employees to initial after they have performed approval functions. (The term voucher may also be applied to the group of documents supporting a cash disbursement.), in this usage, is an authorization sheet that provides space for the initials of the employees performing various authorization functions. Authorization functions include such procedures as extending and footing the vendor's invoice; determining the agreement of the invoice, purchase order, and receiving report; and recording the transaction in the accounts. Transactions are recorded in a voucher register—a special journal used to record the liabilities for payment originating in a voucher system. The debit entries are the cost distribution of the transaction, and the credits are Vouchers Payable. Every transaction recorded in a voucher register corresponds to a voucher authorizing future payment of cash. (which normally replaces a purchases journal) by an entry debiting the appropriate asset, liability, or expense account and crediting Vouchers Payable. The separation of the function of invoice verification and approval from the function of cash disbursement is another step that tends to prevent errors and fraud. On the payment date, the voucher and supporting documents are removed from the tickler file and the check is prepared but not signed. The voucher, supporting papers, and the check (complete except for signature) are forwarded to the finance department for signature.

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Illustrative Case

Importance of Cash Controls

One large construction company ignored basic controls over cash disbursements. Unissued checks were stored in an unlocked supply closet, along with Styrofoam coffee cups. The company check-signing machine deposited signed checks into a box that was equipped with a lock. Despite warnings from their independent auditors, company officials found it “too inconvenient” to keep the box locked or to pay attention to the check counter built into the machine. The company maintained very large bank balances and did not bother to reconcile bank statements promptly.

A three-week-old bank statement and a group of paid checks were given to an employee with instructions to prepare a bank reconciliation. The employee noticed that the group of paid checks accompanying the bank statement was not complete. No paid checks could be found to support over \$700,000 in charges on the bank statement. Further investigation revealed that more than \$1 million in unauthorized and unrecorded checks had been paid from various company bank accounts. The checks had been issued out of sequence and had been signed by the company check-signing machine. The company was unable to determine who was responsible for the theft, and the money was never recovered.

In a computerized purchasing system, vendor invoice information will be entered by the accounting department and it may be matched by the computer with purchase order and receiving information that was entered by the other departments. If the information matches, the computer will approve the payment and automatically record the voucher as a payable. Transactions with inconsistencies will not be processed, but will be listed on an exception report for review and follow-up by the operations control group. Just prior to the invoice's due date, the computer will generate a check or an electronic funds transfer in payment of the invoice. If checks are signed by the computer, they need not be sent to the vouchers payable department for mailing. As a further control, the computer software should be designed to identify unusual disbursements for review.

Another control the auditors may expect to find in a well-managed accounts payable department is the monthly balancing of the detailed records of accounts payable (or vouchers) to the general ledger control account. These reconciliations are saved as evidence of the performance of this procedure and as an aid in locating any subsequent errors or fraud.

Vendors' statements, received monthly, should be reconciled promptly with the accounts payable ledger or list of open vouchers, and any discrepancies should be fully investigated. In some industries, it is common practice to make advances to vendors, which are recovered by making percentage deductions from invoices. When advances are made, the auditors should ascertain that procedures are being followed to ensure that deductions from the invoices are being made in accordance with the terms of the agreement.

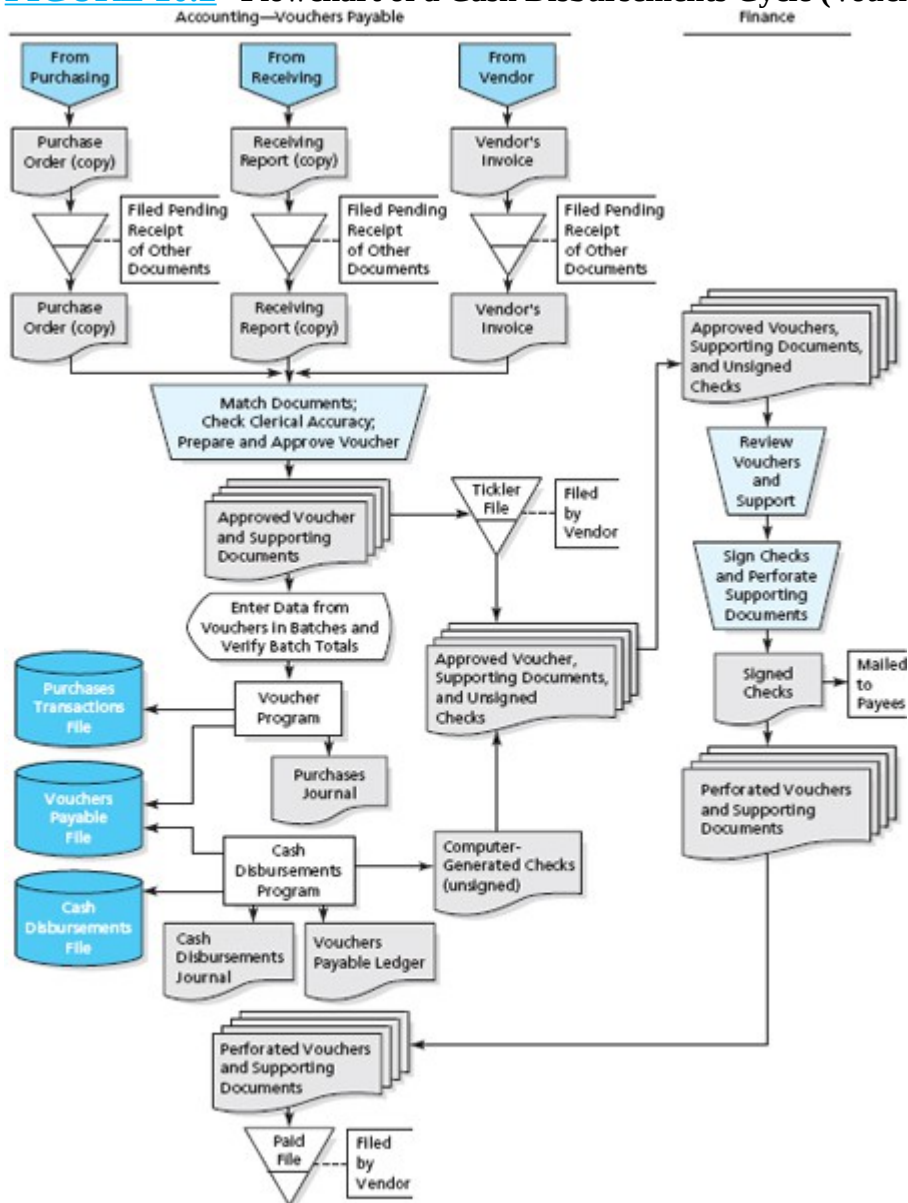
The operation of a voucher system is illustrated in the flowchart in [Figure 10.2](#).

Internal Control over Employee Reimbursements

When employees incur business expenses on behalf of the company, the company must establish effective controls over employee reimbursements. Many companies require employees to submit expense reports with receipts and explanations for their expenditures. The reports are typically approved by the employee's supervisor and submitted to the accounting department for processing. This documentation is used to support the reimbursement through the company's normal payment system. Employees are often reimbursed through direct deposit to their bank accounts.

Many companies issue business credit cards to employees that incur significant amounts of expenses on behalf of the company. Employees are required to document explanations for their credit card expenditures and perhaps also maintain credit card receipts to support the expenditures.

FIGURE 10.2 Flowchart of a Cash Disbursements Cycle (Voucher System)



*This flowchart presents disbursements by check. Disbursements by credit card, debit card, and electronic transfer are similar, with the check being replaced by documentation relating to the particular type of disbursement. The cash receipts discussion in this chapter discusses these alternate forms of

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Internal Control Aspects of Petty Cash Funds

Internal control over payments from an imprest petty cash fund is achieved when the custodian of the petty cash fund reviews support from employees seeking reimbursement for their small expenditures on behalf of the company. Further control exists when the custodian requests replenishment of the fund and another individual reviews the support for completeness and authenticity and subsequently defaces that support to prevent reuse.

Audit tests of petty cash emphasize transactions rather than the year-end balance. The auditors may test one or more replenishment transactions by examining petty cash vouchers and verifying their numerical sequence.

Petty cash funds are sometimes kept in the form of separate bank accounts. The bank should be instructed in writing not to accept for deposit in such an account any checks payable to the company. The deposits will be limited to checks to replenish the fund and drawn payable to the bank or to the custodian of the fund. The prohibition against deposit of checks payable to the company is designed to prevent the routing of cash receipts into petty cash, since this would violate the basic assumption of limited disbursements and review at the time of replenishing the fund.

Audit Documentation for Cash

Auditors' working papers for cash typically include a flowchart or a written description of controls. An internal control questionnaire is also often used, especially in larger companies. A related working paper will summarize tests of controls for cash transactions and the assessments of risk for the financial statement assertions about cash.

Additional cash working papers include documentation of risk assessments, an audit program, a lead schedule, cash count sheets, bank confirmations, bank reconciliations, lists of outstanding checks, lists of checks being investigated, recommendations to the client for improving internal control, and notes concerning proper presentation and disclosure of cash in the client's balance sheet.

Audit of Cash

The following steps indicate the general pattern of work performed by the auditors in the audit of cash. Selection of the most appropriate procedures for a particular audit will be guided by the nature of the controls that have been implemented and by the results of the auditors' risk assessment process.

- A. Use the understanding of the client and its environment to consider inherent risks, including fraud risks, related to cash.
- B. Obtain an understanding of internal control over cash.
- C. Assess the risks of material misstatement and design further audit procedures.
- D.

Perform further audit procedures—
tests of controls.

 - 1.
 2. If necessary, revise the risk of material misstatement.
- E.

**Perform further audit procedures—
substantive procedures for cash
transactions and balances.**

 - 1.
 2. Send standard confirmation forms to financial institutions.

- p. Obtain or prepare reconciliations of bank balances and consider the need to reconcile bank accounts.
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- 3.
- 4. Obtain a cutoff bank statement containing the year-end balance sheet date.
- 5. Count and list cash on hand.
- 6. Verify the client's cutoff of cash receipts.
- 7. Analyze bank transfers for the last week of the year.
- 8. Investigate any checks representing late cash receipts.
- 9. Evaluate proper financial statement presentation.

FIGURE 10.3 Objectives of Major Substantive Procedures for Cash Transactions and Balances

Substantive Procedures	Primary Audit Objectives
Obtain analyses of cash balances and reconcile them to general ledger.	<i>Existence and accuracy</i>
Confirm cash balances with financial institutions. Obtain reconciliations of bank balances and consider reconciling bank activity. Obtain bank cutoff statement. Count cash on hand.	<i>Existence, occurrence, accuracy, cutoff, and rights</i>
Verify the client's cutoff of cash transactions. Analyze bank transfers occurring year-end.	<i>Cutoff, existence, occurrence, rights, and completeness</i>

Investigate payments to related parties.
Evaluate financial statement presentation and disclosure.

Presentation and disclosure

Figure 10.3 relates these substantive procedures to the primary audit objectives.

A. Use the Understanding of the Client and Its Environment to Consider Inherent Risks, Including Fraud Risks, Related to Cash.

Risks of material misstatement arise jointly from inherent risk and control risk. Most inherent risks relate to business risks faced by the client's management. In the area of cash and financial investments, management is particularly concerned with business risks related to the possible theft of these liquid assets. This is also a significant concern of the auditors as most misstatements of assets involve overstatement.

LO4

Use the understanding of the client and its environment to consider inherent risks, including fraud risks, related to cash.

In addition to concerns about the overstatement of cash, auditors are aware that cash may have been improperly abstracted during the period, even though the year-end cash may be properly stated. To distinguish between the situations, assume that the client's balance sheet shows "Cash \$250,000." For most clients, the primary risks are that errors or fraud either (1) create a situation in which \$250,000 overstates actual cash, or (2) create a situation in which the \$250,000 recorded year-end balance should be higher.



Concerning the first risk (overstated cash), a shortage may have been concealed merely by the insertion of a fictitious check in the cash on hand at year-end, or by the omission of an outstanding check from the year-end bank reconciliation. Note that the omission of an outstanding check may be indicative of either an error or fraud. For example, poor internal control may result in a situation in which human error resulted in the check not being recorded in disbursements. On the other hand, although recorded in cash disbursements, the check may have been omitted from the outstanding check list to allow the individual who has embezzled that amount of cash to hide fraud.

Concerning the second risk—the year-end cash is correct, but should be higher—the auditors' problem is not misstated cash, but fraud and its effect on other accounts. Consequently, the auditors have in mind such basic questions as: (1) Do the client's records reflect all cash transactions that took place during the year? and (2) Were all cash payments properly authorized and for a legitimate business purpose? Examples of fraud that may be disclosed in searching for answers to these questions are:

p. Interception of cash receipts before any record is made.

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1.

2. Payment for materials not received.

3. Duplicate payments.
4. Overpayments to employees or payments to fictitious employees.
5. Payments for personal expenditures of officers or related parties.

Based on their knowledge of the client and its environment, the auditors may identify other business risks that result in risks of material misstatements. In some engagements, the auditors may be particularly concerned with the risk of the completeness of recorded cash. As an example, management of a privately held company may be motivated to understate assets (including cash) to minimize income taxes. Also, for a particular client there may be a significant risk that management maintains bank accounts not recorded on the books for such purposes as making illegal bribes. Thus, in such situations, there is a heightened risk that not all cash may be recorded in the financial records. In other cases, the manner in which the client collects cash may present significant business and inherent risks. For example, a charitable organization may receive a large amount of funds from cash donations, creating a significant inherent risk that not all cash donations may be received and recorded.

The auditors also may identify fraud risks related to cash transactions. In such cases, the auditors should obtain an understanding of the programs and controls used by management to mitigate these risks and determine whether the controls have been implemented. Strengths and weaknesses in the client's internal control serve to mitigate or increase the effects of these fraud risks.

B. Obtain an Understanding of Internal Control over Cash.

In the audit of a small business, the auditors may prepare a written description of controls, based upon the questioning of owners and employees and upon firsthand observation. For larger companies, a flowchart or internal control questionnaire is usually employed to describe internal control. An internal control questionnaire for cash receipts was illustrated in [Chapter 7](#). Among the questions included in a questionnaire for cash disbursements are whether all disbursements (except those from petty cash) are made by prenumbered checks and whether voided checks are marked “void” and saved. The existence of these controls permits the auditors to determine that all disbursements have been recorded by accounting for the sequence of checks issued or voided during the period.

Other points to be made clear by the questionnaire include (1) whether check-signing authority is restricted to selected executives not having access to accounting records or to vouchers and other documents supporting checks submitted for signature, and (2) whether checks are mailed directly to the payees after being signed. The internal control questionnaire will also cover cash disbursements for payroll and for dividends, as well as bank reconciliation procedures.

After the auditors have prepared a flowchart (or other description) of internal control, they will conduct a walk-



LO5

Obtain an understanding of internal control over cash.

through of the system. The term *walk-through* means to trace a transaction or a few transactions through each step of the system to determine that transactions actually are being processed in the manner indicated by the flowchart. The walk-through allows the auditors to determine that internal control as described in the working papers has actually been implemented.

As the auditors verify their understanding of the cash receipts and disbursements cycles, they will observe whether there is appropriate segregation of duties and inquire about who performed various functions throughout the year. They will also inspect the various documents and reconciliations that are important to the client's internal control over cash receipts and disbursements. Cash forecasts or budgets also will be inspected and the auditors will review the evidence of the follow-up on variances from forecasted amounts of receipts and disbursements. In some cases, the auditors will review exception reports generated by the computer and the evidence of the follow-up on them. These tests of controls provide the auditors with evidence to support their assessed level of control risk.

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C. Assess the Risks of Material Misstatement and Design Further Audit Procedures.

After obtaining an understanding of the client's internal control over cash receipts and disbursements, the auditors determine their planned assessed levels of the risks of material misstatement (or the separate inherent and control risks) for the assertions about cash. If additional evidence of effectiveness of the controls is needed to support these assessed levels, the auditors will design additional tests of control. In designing these tests, the auditors must decide which ones will result in sufficient reductions in substantive procedures to justify the time spent performing them.

By considering these risk assessments, the auditors are able to identify “what could go wrong” to cause the cash accounts to be materially misstated. [Figures 10.4](#) and [10.5](#) provide examples of possible material misstatements of cash that may be identified by the auditors based on the client's operations and environment, and on weaknesses in its internal control over cash receipts and cash disbursements. Once these risks of material misstatement have been identified and assessed, the auditors can plan appropriate substantive procedures that address them.



LO6

Assess the risks of material misstatement of cash and design further audit procedures, including tests of controls and substantive procedures, to address the risks.

D. Perform Further Audit Procedures—Tests of Controls.

1. Examples of Tests of Controls.

Tests directed toward the effectiveness of controls help to evaluate the client's internal control and determine whether the auditors' planned assessed levels of the risks of material misstatement can be supported. Certain tests of controls are performed as the auditors obtain an understanding of the client's internal control; these tests were described in our discussion of that process. The following are examples of typical further tests of controls.

a. Test the Accounting Records and Reconciliations by Reperformance.

To determine that the client's accounting procedures are operating effectively, the auditors perform tests of the accuracy of the client's journals and ledgers. In a computer-based system, journal and ledger entries may be created simultaneously from the same source documents, and the auditors might choose to use computer assisted audit techniques (CAATs) to test the accuracy of the accounting records.

In a manual system, information on source documents is entered first in a journal; at a later date the information is

summarized and posted from journals to ledgers. The auditors must manually determine that the documents are accurately entered to the journals, the journals are accurately footed, and the data are properly posted to the ledgers. The auditors also may decide to test the client's procedures for reconciling bank (financial institution) accounts. They may select a sample of the reconciliations performed during the year, noting who performed them, and *reperform* the reconciliation process by reference to accounting records, bank statements, and canceled checks.

b. Compare the Details of a Sample of Cash Receipts Listings to the Cash Receipts Journal, Accounts Receivable Postings, and Authenticated Deposit Slips.

Satisfactory internal control over cash receipts demands that each day's collections be deposited intact no later than the next banking day. To provide assurance that cash receipts have been deposited intact, the auditors should compare the detail of the original cash receipts listings (mailroom listings and register tapes) to the detail of the daily deposit tickets. The *detail* of cash receipts refers to a listing of the amount of each individual check and the total amount of currency composing the day's receipts.

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FIGURE 10.4 Potential Misstatements—Cash Receipts

Description of Misstatement	Examples	Internal Control Weaknesses that Increase the Risk of Misstatement
Recording fictitious cash receipts	Fraud: <ul style="list-style-type: none"> • 	<ul style="list-style-type: none"> •

Failure to record receipts from cash sales

Fraud:

-

-

- Inadequate controls for receipts, sales tapes and accounting records for reconciling bank accounts

Error:

- A bookkeeper accidentally omits the recording of the receipts from one cash register for the day

Failure to record cash from collection of accounts receivable

Fraud:

-

-

- Lack of segregation of duties: employees who have access to cash receipts can make entries into the accounts receivable control account
- Inadequate reconciliation of accounts receivable with control account

- A bookkeeper who has access to cash receipts embezzles cash collected from customers and writes

off the related receivables

Error:

- A bookkeeper accidentally fails to record payment on a receivable

Early (late) recognition of cash receipts—“cutoff problems”

Fraud:

-

-

- Failure to list and deposit basis

Error:

- Recording cash receipts based on bad information about date of receipt

Description of Misstatement

Examples

Internal Control Weaknesses that Increase the Risk of

Inaccurate recording of a purchase or disbursement

Fraud:

-

-

- Ineffective controls for matching receiving documents before payment is authorized

- Ineffective accounting controls may result from incompetent and inexperienced staff, inadequate chart of accounts, or errors in the posting process

Errors:

- A disbursement is made to pay an invoice for goods that have not been received
- Disbursements for travel and entertainment are improperly included with merchandise purchases

Duplicate recording and payment of purchases

Error:

-

-

Unrecorded
disbursements

Fraud:

•

•

Comparison of the daily entries in the cash receipts journal with bank deposits may disclose a type of fraud known as *lapping*. Lapping is the concealment of a cash shortage by delaying the recording of cash receipts. The table on the following page provides an illustration.

If cash collected from customer A is withheld by the cashier, a subsequent collection from customer B may be entered as a credit to A's account. B's account will not be shown as paid until a collection from customer C is recorded as a credit to B. Unless the money abstracted by the cashier is replaced, the accounts receivable as a group remain overstated; but judicious shifting of the overstatement from one account receivable to another may avert protests from

customers receiving monthly statements. The following schedule makes clear how a lapping activity may be carried on. In companies in which the cashier has access to the general accounting records, shortages created in this manner have sometimes been transferred to inventory accounts or elsewhere in the records for temporary concealment.

Lapping is most easily carried on when an employee who receives collections from customers is responsible for the posting of customers' accounts. Familiarity with customers' accounts makes it relatively easy to lodge a shortage in an account that will not be currently questioned.

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Date	Actually Received From	Actual Cash Receipts	Recorded as Received From	Receipts Recorded and Deposited	Receipts Withheld
Dec. 1	Abbott Crane	\$ 750 1,035	Crane	\$1,035	\$ 750
2	Barstow White	750 130	Abbott White	750 130	
3	Crawford Miller	1,575 400	Barstow Miller	750 400	825
		<u>\$4,640</u>		<u>\$3,065</u>	<u>\$1,575</u>

c. Compare the Details of a Sample of Recorded Disbursements in the Cash Disbursements Journal to Accounts Payable Postings, Purchase Orders, Receiving Reports, Invoices, and Paid Checks.

Satisfactory internal control over cash disbursements requires that controls exist to provide assurance that disbursements are properly authorized. Testing cash disbursements involves tracing selected items back through the cash disbursements journal to original source documents, including vouchers, purchase orders, receiving reports, invoices, and paid checks. While examining these documents, the auditors have an opportunity to test many of the controls over cash disbursements. For example, they will notice whether all paid vouchers and supporting documents have been perforated or canceled. Also, they will determine whether agreement exists among the supporting documents and note the presence of all required authorization signatures. The auditors also may review the file of paid checks to test the client's procedures for accounting for the numerical sequence of checks.

2. If Necessary, Revise the Risk of Material Misstatement Based on the Results of Tests of Controls.

When the auditors have completed the procedures described in the preceding sections, they should reassess the level of control risk for each financial statement assertion regarding cash. The auditors then decide what modifications, if any, are necessary to the planned audit program of substantive procedures for cash transactions and balances.

E. Perform Further Audit Procedures—Substantive Procedures for Cash Transactions and Balances.

1. Obtain Analyses of Cash Balances and Reconcile Them to the General Ledger.

The auditors will prepare or obtain a schedule that lists all of the client's cash accounts. For cash in bank accounts, this schedule will typically list the bank, the account number, the account type, and the year-end balance per books. The auditors will trace and reconcile all accounts to the general ledger.

Primary Audit Objectives:	
Existence	<input checked="" type="checkbox"/>
Accuracy	<input checked="" type="checkbox"/>
Cutoff	<input checked="" type="checkbox"/>

2. Confirm Cash Balances with Financial Institutions.

One of the objectives of the auditors' work on cash is to substantiate the existence of the amount of cash shown on the balance sheet. A direct approach to this objective is to confirm amounts on deposit and obtain or prepare reconciliations between bank statements and the accounting records.

Primary Audit Objectives:	
Existence	<input checked="" type="checkbox"/>
Occurrence	<input checked="" type="checkbox"/>
Accuracy	<input checked="" type="checkbox"/>
Cutoff	<input checked="" type="checkbox"/>
Rights	<input checked="" type="checkbox"/>

Confirmation of amounts on deposit by direct communication with financial institution officials is obtained in most audits. Account balances are often confirmed with a standard form as illustrated by [Figure 10.6](#). This standard confirmation form *A confirmation form, agreed to by the AICPA, the American Bankers Association, and the Bank Administration Institute, that is designed to provide corroborating evidence about the client's account balances and outstanding loans.*, agreed to by the AICPA, the American Bankers Association, and the Bank Administration Institute,

addresses only the client's deposit and loan balances. Information identifying accounts and loans and their balances is normally included on the form to assist the financial institution in completing it. Thus, the form is primarily used to corroborate the existence of recorded information. However, the confirmation may also lead to the discovery of additional accounts or loans and, therefore, it provides limited evidence about the completeness of recorded amounts. Although the personnel at the financial institution will not conduct a detailed search of the records, they will include information about additional deposits and loans that they note while completing the confirmation.

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FIGURE 10.6 Confirmation Form

**STANDARD FORM TO CONFIRM ACCOUNT
BALANCE INFORMATION WITH FINANCIAL INSTITUTIONS**

The Fairview Corporation
CUSTOMER NAME

ORIGINAL
To be mailed to accountant

We have provided to our accountants the following information as of the close of business on December 31 20 x3 regarding our deposit and loan balances. Please confirm the accuracy of the information, noting any exceptions to the information provided. If the balances have been left blank, please complete this form by furnishing the balance in the appropriate space below. *Although we do not request or expect you to conduct a comprehensive, detailed search of your records, if during the process of completing this confirmation additional information about other deposit and loan accounts we may have with you comes to your attention, please include such information below. Please use the enclosed envelope to return the form directly to our accountants.

Financial Institution's Name and Address: Security National Bank
1000 Wilshire Boulevard
Los Angeles, California 90017-3562

1. At the close of business on the date listed above, our records indicated the following deposit balance(s):

ACCOUNT NAME	ACCOUNT NO.	INTEREST RATE	BALANCE*
General Account	133-7825	None	\$89,548.92
Payroll Account	133-8765	None	8,212.05

2. We were directly liable to the financial institution for loans at the close of business on the date listed above as follows:

ACCOUNT NO./ DESCRIPTION	BALANCE*	DATE DUE	INTEREST RATE	DATE THROUGH WHICH INTEREST IS PAID	DESCRIPTION OF COLLATERAL
55-8965T Credit Line	\$324,877	6/15/x7	12 ¹ / ₂ %	12/15/x3	Furniture & Fixtures
	\$200,000	3/31/x4	13 ¹ / ₄ %	12/31/x3	Unsecured

Judith Fareri January 16, 20x4
(Customer's Authorized Signature) (Date)

The information presented above by the customer is in agreement with our records. Although we have not conducted a comprehensive, detailed search of our records, no other deposit or loan accounts have come to our attention except as noted below.

Joanne M. Mobus January 31, 20x4
(Financial Institution Authorized Signature) (Date)

Audit Inquiry Clerk
(Title)

EXCEPTIONS AND/OR COMMENTS


Please return this form directly to our accountants: Douglas & Troon, CPAs
800 Hill Street
Los Angeles, CA 90014-7865

*Ordinarily, balances are intentionally left blank if they are not available at the time the form is prepared.

Approval 1990 by American Bankers Association, American Institute of Certified Public Accountants, and Bank Administration Institute. Additional forms available from: AICPA - Order Department, P.O. Box 1000, NY, NY 10108 - 1000

0461 0801

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Illustrative Case

Electronic Confirmation of Cash and Loans

Confirmation.com provides an electronic service for CPAs and financial institutions. This service represents the implementation of a “business plan” developed by Brian Fox, CPA, as a part of an assignment in a master's level course.

While working as a CPA, Brian Fox identified certain inefficiencies and potential for fraud inherent in the written

confirmation process. His vision for a solution, which has similarities to the “Paypal” model, was to develop a secure clearinghouse in which both CPAs and financial institutions could be assured that not only was the confirmation transmission process itself secure, but also that the proper, authorized individuals were responding.

Confirmation.com offers both In-Network and Out-of-Network electronic confirmations. When an audit team begins its fieldwork, they request confirmations electronically through Confirmation.com, which then allows the appropriate individuals at the banks to respond to the requests through the network. While the paper confirmation process ordinarily takes several weeks (at a minimum), electronic confirmation replies are often received within a day. Currently, most large banks and thousands of CPAs use the In-Network services of Confirmation.com. [Confirmation.com's](http://Confirmation.com) Out-of-Network service allows electronic confirmations to be sent to banks outside of the network.

In more and more situations, auditors confirm balances with financial institutions electronically. As indicated in the *Illustrative Case* above, the auditors often use a clearing house approach. The personnel at the financial institution provide the auditors (with the client's authorization) access to a secure Web site that contains the requested information. Alternatively, the information may be provided on a Web site controlled and maintained by a trusted third-party service provider. When Web site location and access information is provided by the financial institution or a trusted third-party service provider, it meets the definition of a written confirmation from a third party and may be considered appropriate. However, if the Web site location and access information is obtained only from the client personnel, the information cannot be considered to be confirmed by a third party. In these situations, there is a risk that client personnel may create a fictitious Web site or account to misstate the balances being confirmed.


The details of other financial arrangements may be confirmed with financial institutions, using separate confirmation letters sent to the individual at the financial institution who is responsible for the client's financial arrangements or is knowledgeable about those arrangements. For example, the auditors may send a separate confirmation form to corroborate compensating balance arrangements or authorized check signers. These confirmation forms are described in detail in [Chapter 15](#).

3. Obtain or Prepare Reconciliations of Bank (Financial Institution) Accounts as of the Balance Sheet Date and Consider the Need to Reconcile Bank Activity for Additional Months.

Determining a company's cash position at the close of the period requires a reconciliation of the balance per the bank statement at that date with the balance per the company's accounting records. Even though the auditors may not be able to begin their fieldwork for some time after the close of the year, they will prepare a bank reconciliation as of the balance sheet date or test the one prepared by the client.

Primary Audit Objectives:	
Existence	<input checked="" type="checkbox"/>
Occurrence	<input checked="" type="checkbox"/>
Accuracy	<input checked="" type="checkbox"/>
Cutoff	<input checked="" type="checkbox"/>
Rights	<input checked="" type="checkbox"/>

If the client has made the year-end reconciliation, there is no need to duplicate the work. However, the auditors should examine the reconciliation in detail to satisfy themselves that it has been properly prepared. Inspection of a reconciliation prepared by the client will include verifying the arithmetical accuracy, comparing balances to the bank statement and ledger account, and investigating the reconciling items. The importance of a careful review of the client's reconciliation is indicated by the fact that a cash shortage may be concealed merely by omitting a check from the outstanding check list or by purposely making an error in addition on the reconciliation.

	Illustrative Case	Controlling Confirmation Requests
--	--------------------------	--

The need to control the confirmation process is illustrated in the Parmalat fraud case. In that case, an *SEC Litigation Release* reports that the auditors received a bank confirmation confirming that a subsidiary of Parmalat held the

equivalent of \$4.8 billion (denominated in euros) in cash and marketable securities in a Bank of America account in New York City. The bank account and marketable securities did not exist.

It is believed that the auditors used Parmalat's internal mail to request financial information, and the confirmation was intercepted by a member of management. According to *The Wall Street Journal*, prosecutors believed that the reply information on the fraudulent confirmation was created in Parmalat's main offices by scanning Bank of America's logo into a computer, printing it out, and then passing the sheet of paper several times through a fax machine to make it look more authentic.

There are many satisfactory forms of bank reconciliations. The form most frequently used by auditors begins with balance per bank and ends with unadjusted balance per the accounting records. The format permits the auditors to post adjusting entries affecting cash directly to the bank reconciliation working paper so that the final adjusted balance can be cross-referenced to the cash lead schedule or to the working trial balance.

The mechanics of balancing the ledger account with the bank statement by no means completes the auditors' verification of cash on deposit. The authenticity of the individual items making up the reconciliation must be established by reference to their respective sources. The balance per the bank statement, for example, is not accepted at face value but is verified by direct confirmation with the bank, as described in the preceding pages. Other verification procedures associated with the reconciliation of the bank statement will now be discussed.

The auditors should investigate any checks outstanding for a long period of time (e.g., six months). If checks remain outstanding for long periods, internal control over cash disbursements is weakened. Employees who become aware that certain checks have long been outstanding and may never be presented have an opportunity to conceal a cash shortage merely by omitting the old outstanding check from the bank reconciliation. Such omissions will serve to increase the apparent balance of cash on deposit and may thus induce an employee to abstract a corresponding amount of cash on hand. It is good practice for the client to eliminate long-outstanding checks of this nature by an entry debiting the Cash account and crediting Unclaimed Wages or another special liability account. This will reduce the work required in bank reconciliations, as well as lessen the opportunity for fraud.

When internal control over the recording of cash receipts and disbursements is considered weak, the auditors may use additional reconciliation procedures. For example, a proof of cash **An audit procedure that reconciles the bank's record of cash activity with the client's accounting records for a test period. The working paper used for the proof of cash is a four-column bank reconciliation.** may be prepared, which, in addition to reconciling the account balance, reconciles cash transactions occurring during a specified period. Specifically, the technique is used to identify:

- Cash receipts and disbursements recorded in the accounting records, but not on the bank statement.
- Cash deposits and disbursements recorded on the bank statement, but not in the accounting records.
- Cash receipts and disbursements recorded at different amounts by the bank than in the accounting records.

A proof of cash is essentially a fraud detection procedure that may be used for any months during the year.

A proof of cash for the test period of September is illustrated in [Figure 10.7](#). Notice that this working paper is so organized that the first and last columns reconcile the cash balance per bank and the balance per accounting records at the beginning of the test period (Column 1) and at the end of this period (Column 4). These outside columns are equivalent to typical monthly bank reconciliations. The two middle columns reconcile the bank's record of deposits with the client's record of cash receipts (Column 2) and the bank's record of paid checks with the client's record of cash disbursements (Column 3).

THE FAIRVIEW CORPORATION
 Account No. 101
 Proof of Cash for September 20X1
 December 31, 20X1

A-6
 SM
 11/15/X1

	Balance 8/31/X1	Deposits	Checks and Charges	Balance 9/30/X1
Per Bank Statement	\$39,236.40 ✓	\$46,001.00 ✓	\$40,362.90 ✓	\$44,874.50 ✓
Deposits in Transit				
at 8/31/X1	600.00 ✓	(600.00)		
at 9/30/X1		837.50		837.50
Outstanding Checks				
at 8/31/X1	(1241.00) ✓		(1241.00)	
at 9/30/X1			3402.00	(3402.00) ✓
Bank Service Charge				
August	4.60 ✓		4.60	
September			(2.80)	2.80 ✓
Check of customer A.D.				
Speeler charged back by Bank				
9/12/X1, redeposited 9/12/X1		(900.00)	(900.00)	
Per Books	\$38,600.00	\$45,338.50	\$41,625.70	\$42,312.80

✓ Traced to client's 8/31/X1 bank statement.

✓ Traced to client's 9/30/X1 bank statement.

✓ Per adding machine tape at A-4-2.

✓ Per adding machine tape at A-4-3.

✓ Traced to general ledger.

Posted cash receipts journal and check registers for 9/X1. Accounted for numerical sequence of all checks issued September 20X1 (26610-6792). No exceptions noted.

K.W. 10/16/X1

Next, consider the source of the figures used in this reconciliation. The amounts “per bank statement” are taken from the September 30 bank statement. The subsequent rows of deposits, checks, and other items are taken from the August and September bank reconciliations, and the amounts “per books” are taken from the client's Cash general ledger account and cash receipts and disbursements journals.

4. Obtain a Cutoff Bank Statement Containing Transactions of at Least Seven Business Days Subsequent to the Balance Sheet Date.

A cutoff bank statement is a bank statement covering a specified number of business days (usually 7 to 10) after the client's balance sheet date. Auditors use this statement to determine that checks issued on or before the balance sheet date and paid during the cutoff period were listed as outstanding on the year-end bank reconciliation. Another use is to determine that reconciling items shown on the year-end bank reconciliation have cleared the bank within a reasonable amount of time. is a statement covering a specified number of business days (usually 7 to 10) following the end of the client's fiscal year. The client will request the bank to prepare such a statement and mail it directly to the auditors. The auditors may also obtain cutoff information electronically from the bank's Web site. In order to accept this as appropriate evidence, the auditors must become satisfied that the Web site is valid. This information is used to test the accuracy of the year-end reconciliation of the company's bank accounts. It allows the auditors to examine firsthand the checks (ordinarily on computer media) listed as outstanding and the details of deposits in transit on the company's reconciliation.

Primary Audit Objectives:	
Existence	<input checked="" type="checkbox"/>
Occurrence	<input checked="" type="checkbox"/>
Accuracy	<input checked="" type="checkbox"/>
Cutoff	<input checked="" type="checkbox"/>
Rights	<input checked="" type="checkbox"/>

With respect to checks that were shown as outstanding at year-end, the auditors should determine the dates on which the bank paid these checks. By noting the dates of payment of these checks, the auditors can determine whether the time intervals between the dates of the check and the time of payment by the bank were unreasonably long. Unreasonable delay in the presentation of these checks for payment constitutes a strong implication that the checks were not mailed by the client until some time after the close of the year. The appropriate adjusting entry in such cases

consists of a debit to Cash and a credit to a liability account.

In examining the cutoff bank statement, the auditors will also watch for any paid checks issued on or before the balance sheet date but not listed as outstanding on the client's year-end bank reconciliation. Thus, the cutoff bank statement provides assurance that the amount of cash shown on the balance sheet was not overstated by omission of one or more checks from the list of checks outstanding.

Check 21 Act

Historically, checks have taken days to clear in large part because they have literally been flown about the country in the clearing process. Under the Check Clearing for the 21st Century Act ("Check 21 Act") ***This act allows financial institutions to create and process electronic "substitute checks" in place of customer written hard-copy checks. The purpose of this act is to decrease the time for check clearing.*** checks may be processed electronically. Electronic processing involves creating a "substitute check," an electronic image of the original that is processed in hours rather than days. The substitute check is the legal equivalent of the original check for all purposes. Under the Check 21 Act, any financial institution in the check clearing process may *truncate* (destroy) paper checks and create a substitute check for processing.

This new form of check processing has several audit implications. First, if the client's checks are processed electronically, the auditors who wish to see evidence of the check itself must rely upon the substitute check because the original check will no longer be available; the substitute check may be available in paper, electronic, or both forms. Second, it becomes virtually impossible for a client to kite checks (manipulate bank balances so that temporarily overstated cash balances conceal a cash shortage, as discussed later in this chapter) if its financial institutions use this form of processing. However, the auditors should realize that while processing will be much faster, they should still expect reconciliations to include outstanding checks, because some checks drawn near the end of the year may be sent through the mail, and some checks will not be promptly presented for payment by payees.

5. Count and List Cash on Hand.

Cash on hand ordinarily consists of undeposited cash receipts, petty cash funds, and change funds. The petty cash funds and change funds may be counted at any time before or after the balance sheet date; many auditors prefer to make a surprise count of these funds.

Primary Audit Objectives:	
Existence	<input checked="" type="checkbox"/>
Occurrence	<input checked="" type="checkbox"/>
Accuracy	<input checked="" type="checkbox"/>
Cutoff	<input checked="" type="checkbox"/>
Rights	<input checked="" type="checkbox"/>

The count of cash on hand is of special importance in the audit of banks and other financial institutions. Whenever auditors make a cash count, they should insist that the *custodian of the funds be present throughout the count*. At the completion of the count, the auditors should obtain from the custodian a signed and dated acknowledgment that the funds were counted in the custodian's presence and were returned intact by the auditors. Such procedures avoid the possibility of an employee trying to explain a cash shortage by claiming that the funds were intact when turned over to the auditors.

A first step in the verification of cash on hand is to establish control over all negotiable assets, such as cash funds, securities and other investments, notes receivable, and warehouse receipts. Unless all negotiable assets are verified at one time, an opportunity exists for a dishonest officer or employee to conceal a shortage by transferring it from one asset category to another.

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It is not uncommon to find included in cash on hand some personal checks cashed for the convenience of officers, employees, and customers. Such checks, of course, should not be entered in the cash receipts journal because they are merely substitutes for currency previously on hand. The auditors should determine that these checks are valid and collectible, thus qualifying for inclusion in the balance sheet figure for cash. This may be accomplished by the auditors' examination of the last bank deposit for the period and determination that it includes all checks received through year-end. The auditors will retain a validated deposit slip from this deposit for comparison to any checks subsequently charged back by the bank.

6. Verify the Client's Cutoff of Cash Receipts and Cash Disbursements.

An accurate cutoff of cash receipts (and of cash disbursements) at year-end is essential to a proper statement of cash on the balance sheet. The balance sheet figure for cash should include all cash received on the final day of the year and none received subsequently. If the auditors can arrange to be present at the client's office at the close of business on the last day of the fiscal year, they will be able to verify the cutoff by counting the undeposited cash receipts. It will then be impossible for the client to include in the records any cash received after this cutoff point without the auditor being aware of such actions.

Primary Audit Objectives:	
Cutoff	<input checked="" type="checkbox"/>
Existence	<input checked="" type="checkbox"/>
Occurrence	<input checked="" type="checkbox"/>
Rights	<input checked="" type="checkbox"/>
Completeness	<input checked="" type="checkbox"/>

Of course, the auditors cannot visit every client's place of business on the last day of the fiscal year, nor is their presence at this time normally essential to a satisfactory verification of cash. As an alternative to a count on the balance sheet date, auditors can verify the cutoff of cash receipts by determining that deposits in transit as shown on the year-end bank reconciliation appear as credits on the bank statement on the first business day of the new year. Results of the auditors' consideration of internal control will dictate the necessary scope of these procedures.

The auditors should be aware of possible window dressing **Action taken by the client shortly before the balance sheet date to improve the financial picture presented in the financial statements.** related to cash transactions. For example, if the cash receipts are not deposited daily, cash received for a few days after the close of the year may be included in a deposit dated as of year-end, thus overstating the cash balance at the balance sheet date.

Other approaches to window dressing improve but do not outright misrepresent the cash position. For example, a corporate officer who has borrowed money from the corporation may repay the loan just before the end of the year and then promptly obtain the loan again after year-end; in such a situation, disclosure in the notes to the financial statements may be appropriate.

Other forms of window dressing do not require action by the auditors. Many companies make strenuous efforts at year-end to achieve an improved financial picture by rushing shipments to customers, pressing for collection of receivables, and sometimes paying liabilities down to an unusually low level. Such efforts to improve the financial picture to be reported are not improper. Before giving approval to the balance sheet presentation of cash, the auditors must exercise their professional judgment to determine whether the client has engaged in window dressing of a nature that causes the financial statements to be misleading.

7. Analyze Bank Transfers for the Last Week of the Audit Year and the First Week of the Following Year.

The purpose of analyzing bank transfers is to disclose overstatements of cash balances resulting from kiting **Manipulations causing an amount of cash to be included simultaneously in the balance of two or more bank accounts. Kiting schemes are based on the float period—the time necessary for a check deposited in one bank to clear the bank on which it was drawn.** Many businesses maintain checking accounts with a number of banks and often find it necessary to transfer funds from one bank to another. When a check drawn on one bank is deposited in another, several days (called the float period) usually pass before the check clears the bank on which it is drawn. During this period, the amount of the check is included in the balance on deposit at both banks. *Kiting* refers to manipulations that utilize such temporarily overstated bank balances to conceal a cash shortage or meet short-term cash needs. Note that kiting is much more difficult in an environment of ever-increasing electronic transfers between accounts (rather than using paper checks) due to the virtual disappearance of the float period.

Primary Audit Objectives:	
Cutoff	<input checked="" type="checkbox"/>
Existence	<input checked="" type="checkbox"/>
Occurrence	<input checked="" type="checkbox"/>
Rights	<input checked="" type="checkbox"/>
Completeness	<input checked="" type="checkbox"/>

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Auditors can detect manipulations of this type by preparing a schedule of bank transfers for a few days before and after the balance sheet date. This working paper lists all bank transfers and shows the dates that the receipt and disbursement of cash were recorded in the cash journals and on the bank statements. A partial illustration of a schedule of bank transfers is shown below.

Check No.	Bank Accounts		Amount	Date of Disbursement		Date of Receipt	
	From	To		Books	Bank	Books	Bank
5897	General	Payroll	\$30,620	12/28	1/3	12/28	12/28
6006	General	Branch 4	24,018	1/2	1/4	12/30	12/30
6029	Branch 2	General	10,000	1/3	1/5	1/3	12/31

Disclosure of Kiting

By comparing the dates on the schedule of bank transfers, auditors can determine whether any manipulation of the cash balance has taken place. The increase in one bank account and decrease in the other bank account should be recorded in the cash journals in the same accounting period. Notice that Check No. 6006 in the transfer schedule was recorded in the cash journals as a receipt on December 30 and a disbursement of January 2. As a result of recording the debit and credit parts of the transaction in different accounting periods, cash is overstated on December 31. For the cash receipts journal to remain in balance, some account must have been credited on December 30 to offset the debit to Cash. If a revenue account was credited, the results of operations were overstated along with cash.

Kiting may also be used to conceal a cash shortage. Assume, for example, that a financial executive misappropriates \$10,000 from a company's general checking account. To conceal the shortage on December 31, the executive draws a check transferring \$10,000 from the company's branch bank account to the general account. The executive deposits the transfer check in the general account on December 31, but records the transfer in the accounting records as occurring early in January. As of December 31, the shortage in the general account has been replaced, no reduction has yet been recorded in the branch account, and no shortage is apparent. Of course, the shortage will reappear in a few days when the transfer check is paid from the branch account.

A bank transfer schedule should disclose this type of kiting because the transfer deposit appears on the general account bank statement in December, while the transaction is not recorded in the cash journals until January. Check No. 6029 in the transfer schedule illustrates this discrepancy. These illustrations suggest the following rules for determining when it is likely that a cash transfer has misstated the cash balance:

1. The dates of recording the transfer *per the books* (from the cash disbursements and cash receipts journals, respectively) are from different financial statement periods, *or*
2. The date the check was recorded *by the bank* (either the disbursement or the receipt, but not both) is from the financial statement period prior to when it is recorded on the books.

A third type of kiting uses the float period to meet short-term cash needs. For example, assume that a business does not have sufficient cash to meet the month-end payroll. The company might draw a check on its general account in one bank, deposit it in a payroll account in another bank, and rely upon subsequent deposits being made to the general account before the transfer check is presented for payment. If the transfer is properly recorded in the accounting records, this form of kiting will not cause a misstatement of the cash balance for financial reporting purposes. However, banks attempt to detect this practice and may not allow the customer to draw against the deposit until the check has cleared the other account. In some deliberate schemes to defraud banks, this type of kiting has been used to create and conceal overdrafts of millions of dollars.

p. 404

Primary Audit Objectives:	
Presentation	<input checked="" type="checkbox"/>

8. Investigate Any Checks Representing Large or Unusual Payments to Related Parties.

Any large or unusual checks payable to directors, officers, employees, affiliated companies, or cash should be carefully reviewed by the auditors to determine whether the transactions (1) were properly authorized and recorded and (2) are adequately disclosed in the financial statements.

To provide assurance that cash disbursements to related parties were authorized transactions and were properly recorded, the auditors should determine that each such transaction has been charged to the proper account, is supported by adequate vouchers or other documents, and was specifically approved in advance by an officer other than the one receiving the funds.

The need for financial statement disclosure of transactions with related parties was discussed in [Chapter 5](#). To

determine that such transactions are adequately disclosed, the auditors must obtain evidence concerning the relationship between the parties, the substance of each transaction (which may differ from its form), and the effect of each transaction upon the financial statements. Disclosure of related party transactions should include the nature of the relationships, a description of the transactions, and the dollar amounts involved.

9. Evaluate Proper Financial Statement Presentation and Disclosure of Cash.

The balance sheet figure for cash should include only those amounts that are available for use in current operations. A bank deposit that is restricted in use (for example, cash deposited with a trustee for payments on long-term debt) should not be included in cash. Agreements to maintain *compensating balances* should be disclosed. The auditors must also make sure that the caption “Cash” or “Cash and Equivalents” on the client’s balance sheet corresponds to that used in the statement of cash flows.

Primary Audit Objectives:
Presentation <input checked="" type="checkbox"/>

Interim Audit Work on Cash

To avoid a concentration of audit work shortly after the year-end, CPA firms try to complete as many auditing procedures as possible on an interim basis during the year. The consideration of internal control over cash, for example, can be performed in advance of the client’s year-end. The audit work on cash at year-end can then be limited to such substantive procedures as a review of the client’s bank reconciliations, confirmation of year-end bank balances, investigation of the year-end cutoff, and a general review of cash transactions during the interval between the interim work on cash and the end of the period.

Financial Investments

The most important group of financial investments, from the viewpoint of the auditors, consists of marketable stocks and bonds because they are found more frequently and usually are of greater dollar value than other kinds of investment holdings. Other types of investments often encountered include commercial paper issued by corporations, mortgages and trust deeds, and the cash surrender value of life insurance policies. The auditors also must be concerned with derivatives that are used to hedge various financial and operational risks or for speculation. Derivatives are financial instruments that “derive” their value from other financial instruments, underlying assets, or indexes. For example, a simple derivative would involve a commitment by a company to purchase a commodity at a certain price at some point in the future. Other derivatives are much more complex, involving, for example, relationships between fluctuations in European interest rates and the price of copper.

LO7

Describe the risks involved in auditing financial investments, including why the auditors might need specialized skills.

The Need for Specialized Knowledge

The audit of financial investments can be very complex, requiring specialized skill or knowledge in performing audit tasks such as:

- Identifying controls at service organizations that provide financial services and are part of the client's information system.
- Obtaining an understanding of information systems for securities and derivatives that are highly dependent on computer technology.
- p. 405

Applying complex accounting principles to various types of financial investments.

- Understanding the methods used to determine the fair values of financial investments, especially those that must be valued using complex valuation models.
- Assessing inherent and control risk for assertions about derivatives used in hedging activities.

Therefore, the auditors may decide that the assistance of specialists either within or outside the firm is needed to assist in the audit of complex financial investments.



Illustrative Case

Auditing Derivative Transactions

Enron used derivative contracts in its energy trading division as one way of significantly overstating its reported net income. The company purchased and sold long-term futures contracts for commodities, such as gas, for which there were no active markets and therefore no reliable prices to value the contracts for financial statements. Company employees, who benefited directly from the profits made from the trading activities, priced the contracts using discretionary valuation models based on their own assumptions and methods. Unrealized trading “gains” accounted for slightly more than half of the company's \$1.41 billion reported pretax profit for 2000 and about one-third of its reported pretax profit for 1999.

The Auditors' Objectives in Auditing Financial Investments

The auditors' *objectives* in the examination of financial investments are to:

1. Use the understanding of the client and its environment to assess *risks* including fraud risks.
2. Obtain an understanding of *internal control*

LO8

Identify the auditors' objectives in the audit of financial

investments.

3.

Assess the risks of *material misstatements* of investments and design further audit procedures that:

- a.
- b. Establish the *completeness* of financial in
- c. Verify the *cutoff* of investment transaction
- d. Determine that the client has *rights* to rec
- e. Determine that the *valuation* of financial i accordance with the cost, fair value, or eq depreciation in value is appropriately rec
- f. Determine that the *presentation* and losses are appropriate.

In conjunction with their audit of financial investments, the auditors will also verify the related accounts of interest income and dividends, accrued interest revenue, and realized and unrealized gains and losses on investments.

The liquid nature of financial investments that are marketable makes the potential for fraud high. Auditors must coordinate their cash and marketable securities audit procedures to detect any possible fraud involving unauthorized substitution (e.g., the sale of securities to hide a cash shortage) between the accounts.

Internal Control over Financial Investments

The major elements of adequate internal control over financial investments include the following:

- Formal investment policies that limit the nature of investments in securities and other financial instruments.
- p. An investment committee of the board of directors that authorizes and reviews financial investment activities for compliance with investment policies.
-
- Separation of duties between the executive authorizing purchases and sales of securities and derivative instruments, the custodian of the securities, and the person maintaining the records of investments.
- Complete detailed records of all securities and derivative instruments owned and the related provisions and terms.

LO9

Describe typical internal controls over the business processes related to financial investments.

- Registration of securities in the name of the company.
- Periodic physical inspection of securities on hand by an internal auditor or an official having no responsibility for the authorization, custody, or record keeping of investments.
- Determination of appropriate accounting for complex financial instruments by competent personnel.

In many concerns, segregation of the functions of custody and record keeping is achieved by the use of an independent safekeeping agent, such as a stockbroker, bank, or trust company. Since the independent agent has no direct contact with the employee responsible for maintaining accounting records of the investments in securities, the possibilities of concealing fraud through falsification of the accounts are greatly reduced. If securities that exist in certificate form are not placed in the custody of an independent agent, they should be kept in a bank safe-deposit box under the joint control of two or more of the company's officials. *Joint control* means that neither of the two custodians may have access to the securities except in the presence of the other. A list of securities in the box should be maintained in the box, and the deposit or withdrawal of securities should be recorded on this list along with the date and signatures of all persons present. The safe-deposit box rental should be in the name of the company, not in the name of an officer having custody of securities.

Complete detailed records of all securities and derivative instruments owned are essential to satisfactory control. These records frequently consist of a subsidiary record for each security and derivative instrument, with such identifying data as the exact name, face amount or par value, certificate number, number of shares, date of acquisition, name of broker, cost, terms, and any interest or dividend payments received. Actual interest and dividends should be compared to budgeted amounts, and significant variances should be investigated. The purchase and sale of investments often is entrusted to a responsible financial executive, subject to frequent review by an investment committee of the board of directors.

An internal auditor or other responsible employee should, at frequent intervals, inspect the securities on hand, compare the serial numbers and other identifying data of the securities examined with the accounting records, and reconcile the subsidiary record for securities with the control account. If the entity engages in derivative transactions, the individual should also review the terms of derivative instruments for compliance with investment policies and proper financial accounting and disclosure.

In some situations, the auditors may need to consider controls at a service organization because it provides services that are part of the client's information system. Such services include those that affect the initiation of transactions, accounting processing or accounting records, or financial statement reporting. As an example, the auditors must be concerned about the controls of a stockbroker that initiates purchases and sales of investments and reports the results to the client. As described in [Chapter 8](#), the auditors may obtain information about the controls at a service organization by reviewing user manuals or other systems documentation, reviewing service contracts, obtaining the report of a service auditor, or personally visiting the service organization.

Internal Control Questionnaire

A questionnaire used by the auditors in assessing controls relating to financial investments will include questions such as the following: Does the client have investment policies that reflect appropriate risk management? Are securities and similar instruments under the joint control of responsible officials? Are all persons having access to securities properly bonded? Is an independent safekeeping agent retained? Are competent personnel involved in reviewing and accounting for derivative instruments? Are all purchases and sales of securities and derivatives authorized by a financial executive and reviewed by an investment committee of the board of directors?

Audit of Financial Investments

general pattern of work performed by the auditors in the audit of financial investments. Selection of the most appropriate procedures for a particular audit will be guided by the nature of the controls that have been implemented and by the results of the auditors' risk assessment process.

Describe tests of controls and substantive procedures used to audit financial investments.

A. Use the understanding of the client and its environment to consider inherent risks, including fraud risks related to financial investments.

B. Obtain an understanding of internal control over financial investments.

C. Assess the risks of material misstatement and design further audit procedures.

D.

Perform further audit procedures—tests of controls.

1.

2. If necessary, revise the risk of material misstatement.

E.

Perform further audit procedures—substantive procedures for investment transactions and year-end balances.

1.

2. Inspect securities on hand and review agreements.

3. Confirm securities and derivative instruments.

4. Vouch selected purchases and sales of financial investment transactions.
5. Review investment committee minutes and reports.
6. Perform analytical procedures.
7. Make independent computations of revenue and interest income.
8. Inspect documentation of management's valuation of investments.
9. Evaluate the method of accounting for investments.
10. Test the valuation of financial investments.
11. Evaluate financial statement presentation.

Risks of Material Misstatement of Financial Investments

As discussed earlier, the fact that securities are often very liquid significantly increases the risk of fraud. In addition, the accounting for financial investments can be very complex, increasing the risk that the investments will not be valued appropriately. If client personnel engage in speculation, they may be motivated to use various improper techniques to hide or delay reporting losses. The use of derivatives almost always increases the risk of material misstatement of the financial statements. In assessing the risks of material misstatement, the auditors will consider these inherent risks in combination with the control risks identified by the auditors' understanding of the client and its environment and tests of controls over investments.

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FIGURE 10.8 Potential Misstatements—Financial Investments

Description of Misstatement	Examples	Internal Control Weaknesses that Increase the Risk of Misstatement
Misstatement of recorded value of investments	Error: <ul style="list-style-type: none"> • 	<ul style="list-style-type: none"> • Ineffective board of directors; ineffective internal audit function; "to

conducive to ethical conduct
meet earnings targets

Fraud:

- Misstatement of the value of closely held investment
- Recording fictitious securities

Unauthorized investment transactions

Fraud:

-

•

Incomplete recording of investments

Error:

-

•

- Inadequate monitoring by

Some of the risks of material misstatement identified by the auditors may be considered to be significant risks that require special audit consideration. As an example, if the client uses foreign currency futures contracts to hedge its exposure to foreign investments and does not have accounting personnel with adequate knowledge of the related accounting standards, the auditors may decide to evaluate the accounting for all or most of the transactions occurring during the period.

Figure 10.8 provides illustrations of typical errors and fraud that the auditors might identify and assess in the audit of financial investments. Such misstatements may arise due to improper valuation, unauthorized transactions, or inadequate disclosure of such matters as derivative trading activities.

Substantive Procedures for Financial Investments

AICPA AU 501 (PCAOB 332) provides guidance on auditing financial investments, including the types of substantive procedures that are typically performed. Figure 10.9 presents these substantive procedures, which are described in the next section.

1. Obtain or Prepare Analyses of the Investment Accounts and Related Revenue, Gain, and Loss Accounts and Reconcile Them to the General Ledger.

The analysis of financial investments will show the beginning and ending balances for the year, purchases and sales of investments during the year, interest and dividends earned, and realized and unrealized gains and losses. The auditors may verify the beginning balances of investments by reference to the prior year's audit working papers. If numerous purchases and sales of investments have occurred during the year, separate schedules of those transactions may support an overall summary schedule of investments. The auditors will make certain that totals on the schedules agree with totals recorded in the general ledger.

Primary Audit Objectives:	
Existence	<input checked="" type="checkbox"/>
Rights	<input checked="" type="checkbox"/>
Occurrence	<input checked="" type="checkbox"/>

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FIGURE 10.9 Objectives of Major Substantive Procedures for Financial Investments

Substantive Procedures	Primary Audit Objectives
Obtain analysis of investments and related accounts and reconcile to ledger.	Existence and rights Occurrence
Inspect securities on hand and review derivatives.	Existence and rights Occurrence and accuracy
Confirm securities and derivative instruments with holders and counterparties.	Completeness Cutoff
Vouch selected purchases and sales of investments during the year.	Valuation
Verify the client's cutoff of investment transactions.	

Review investment committee minutes and reports. **Completeness**

Perform analytical procedures. **Existence**
Make independent computations of revenues from securities. **Rights**
Occurrence
Completeness

Inspect documentation of management transactions as hedges. **Valuation**
Presentation
Evaluate the method of accounting for investments.
Test the valuation of financial investments.

Evaluate financial statement presentation of investments. **Disclosure of financial**
Investments

2. Inspect Securities on Hand and Review Agreements Underlying Derivatives.

The auditors will count securities held by the client at year-end, verify that the securities are registered in the company's name, and record in the working papers a description of the securities, including the serial numbers. When the client's records indicate that a particular security has been held since the last audit, the auditors may compare the serial number of the certificate with that shown in the prior year's working papers. This will allow the auditors to detect securities that have been sold without authorization during the year and replaced before this year's audit.

Primary Audit Objectives:	
Existence	<input checked="" type="checkbox"/>
Occurrence	<input checked="" type="checkbox"/>
Rights	<input checked="" type="checkbox"/>
Completeness	<input checked="" type="checkbox"/>
Accuracy	<input checked="" type="checkbox"/>
Valuation	<input checked="" type="checkbox"/>
Cutoff	<input checked="" type="checkbox"/>

While the count of securities ideally is made at the balance sheet date, concurrently with the count of cash and other negotiable instruments, this is not always possible. When not possible, if the securities are kept in a bank safe-deposit box, the client may instruct the bank in writing on the balance sheet date that no one is to have access to the box unless accompanied by the auditors. This arrangement makes it possible to count the securities at a more convenient time after the balance sheet date. Also, banks maintain records of access to safe-deposit boxes that can be examined by the auditors to determine who has had access to the box and at what dates. A representative of the client should be present when the auditors count the securities, and that individual should acknowledge in writing that the securities were returned intact.

The auditors will also review and analyze the derivative **Financial instruments that "derive" their value from other financial instruments, underlying assets, or indexes. Examples are options, forward contracts, and futures contracts.** instruments and other agreements that may contain embedded derivatives. For example, a loan agreement might contain a provision to swap a fixed interest rate for a variable interest rate under certain circumstances. This analysis is designed to determine that all derivatives are properly recorded and valued in the financial statements.

3. Confirm Securities and Derivative Instruments with Holders and Counterparties.

Client-owned securities and other financial instruments will often be in the hands of brokers or banks for safekeeping. In such cases, the auditors send a confirmation request, signed by the client, to the holders of the investments to determine existence and ownership. If the broker or bank initiates investment transactions and maintains the related accountability for them, or records investment transactions and processes the related data, the auditors should consider obtaining a service auditor's report on the processing of transactions, as described in Chapter 8. The auditors also often confirm the terms of derivative instruments with the counterparties—the other parties obligated under the agreements.

Primary Audit Objectives:	
Existence	<input checked="" type="checkbox"/>
Occurrence	<input checked="" type="checkbox"/>
Rights	<input checked="" type="checkbox"/>
Completeness	<input checked="" type="checkbox"/>
Accuracy	<input checked="" type="checkbox"/>
Valuation	<input checked="" type="checkbox"/>
Cutoff	<input checked="" type="checkbox"/>

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As with cash information from financial institutions, the auditors may decide to get evidence about the client's securities electronically. This approach is appropriate providing that the auditors can be assured that the information is obtained from a valid Web site without possibility of client manipulation.

4. Vouch Selected Purchases and Sales of Financial Investments during the Year and Verify the Client's Cutoff of Investment Transactions.

To determine that investments purchased and sold during the period are recorded properly, the auditors vouch a sample of transactions by reference to brokers' advices*A notification sent by a stockbrokerage firm to a customer reporting the terms of a purchase or sale of securities.* and cash records. In addition, they review transactions for one or two weeks after the balance sheet date to ensure a correct cutoff of transactions. Sometimes sales occur shortly before the balance sheet date but go unrecorded until the securities are delivered to the broker early in the next period. Also, inspection and confirmation procedures will help ensure a proper cutoff of securities transactions.

Primary Audit Objectives:	
Existence	<input checked="" type="checkbox"/>
Occurrence	<input checked="" type="checkbox"/>
Rights	<input checked="" type="checkbox"/>
Completeness	<input checked="" type="checkbox"/>
Accuracy	<input checked="" type="checkbox"/>
Valuation	<input checked="" type="checkbox"/>
Cutoff	<input checked="" type="checkbox"/>

5. Review Investment Committee Minutes and Reports.

Review of investment committee minutes and reports may disclose unrecorded purchases and sales of securities or other financial instruments. This procedure is especially important if the client uses derivatives because transactions giving rise to derivatives may not involve the payment or receipt of cash. For example, if a client engages in a foreign exchange forward contract, there may be no exchange of cash at the time the contract is executed. In addition, derivatives may be embedded in other financial instruments such as a loan agreement.

Primary Audit Objectives:	
Completeness	<input checked="" type="checkbox"/>

6. Perform Analytical Procedures or Make Independent Computations.

The auditors can use analytical procedures to test the reasonableness of the amounts of recorded dividend and interest income, or they can verify the amounts by independent computation. Dividends that should have been received and recorded can be computed by referring to dividend record books*A reference book published monthly by investment advisory services reporting detailed information concerning all listed and many unlisted securities; includes dividend dates and amounts, current prices of securities, and other condensed financial data.* published by investment advisory services. These books show dividend declarations, amounts, and payment dates for all listed stocks. Interest earned on bonds and notes also can be computed independently by the auditors and compared with recorded amounts in the client's records. This provides evidence that investment income has not been embezzled, the client actually owns the securities recorded in the accounting records, and there are no unrecorded derivative instruments.

Primary Audit Objectives:	
Existence	<input checked="" type="checkbox"/>
Rights	<input checked="" type="checkbox"/>
Occurrence	<input checked="" type="checkbox"/>
Completeness	<input checked="" type="checkbox"/>

7. Inspect Documentation of Management's Intent to Classify Derivative Transactions as Hedging Activities.

To account for a derivative instrument as a hedge of an asset, liability, or future transaction, management must establish at inception the intent to hedge, the method to be used to assess its effectiveness as a hedge, and the measurement approach for determining the ineffective portion of the hedge. Therefore, review of the documentation of management's intent is essential to the audit of the client's accounting for derivative instruments.

Primary Audit Objectives:	
Valuation	<input checked="" type="checkbox"/>
Presentation	<input checked="" type="checkbox"/>

Primary Audit Objectives:	
Valuation	<input checked="" type="checkbox"/>
Presentation	<input checked="" type="checkbox"/>

8. Evaluate the Accounting Methods Used and Test the Valuation.

Organizations have an option in reporting financial investments because they may either follow the guidance in *FASB ASC 320* (formally *FASB No. 115*) or elect the fair value option.¹ *FASB ASC 320* divides securities into three portfolios—trading securities, available-for-sale securities, and held-to-maturity securities. Securities in both the *trading* and *available-for-sale* portfolios are valued at their current market values. Any unrealized gains and losses on securities in the trading portfolio are recorded in the income statement; unrealized gains and losses on securities classified as available-for-sale are excluded from net income and reported in a separate component of stockholders' equity until they are realized. Professional standards allow companies to elect the fair value option for all securities; the fair value option results in unrealized income and losses being recorded on the income statement (as is always the case with trading securities).

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Accounting for derivative instruments is guided by *FASB ASC 815* (formally *FASB No. 133*) and *FASB ASC 825* (formally *FASB No. 159*). Under *FASB ASC 815*, all derivative instruments are valued at their fair values, but the unrealized gains or losses are accounted for differently depending on whether or not the instruments are classified as hedges. Unrealized gains or losses on the effective portions of hedges of recorded assets or liabilities are offset by related increases and decreases in the hedged assets or liabilities. Unrealized gains or losses on the effective portions of hedges of future transactions are recorded as part of other comprehensive income in the client's financial statements. Such gains or losses become adjustments to the recording of the hedged transactions when they occur. Finally, under *FASB ASC 815*, unrealized gains or losses on the ineffective portions of hedge derivatives and nonhedge derivatives are recorded as a part of net earnings in the client's financial statements. As is the case with other securities, *FASB ASC 825* allows an option to companies to choose to use fair value accounting rather than the approach outlined in *FASB ASC 815*.

The fair value of securities and derivatives in many situations may be obtained by reference to sales prices on organized exchanges. If there is not an active market for the securities or derivatives, fair value may be deduced from active markets for similar instruments. However, to use prices from similar markets, the auditors must consider whether adjustments are needed for differences between the instrument being traded in the market and the instrument being valued. Finally, if no active market is available to value the security or derivative, management may have to use a valuation model, such as the Black Sholes option pricing model. In these situations, the auditors must evaluate the reasonableness of the significant assumptions underlying the model. [Chapter 5](#) provides a more detailed discussion of audits of assets valued at fair values.

To audit the fair values of marketable securities or derivatives, current market prices can be obtained by reference to quotes in financial publications, such as *The Wall Street Journal* or various sources on the Internet, or by obtaining representations from securities brokers. If a security or derivative has no active market, management may obtain an appraisal of fair value from a securities appraiser. In such cases, the auditors should refer to AICPA AU 620 (PCAOB 336), which requires that they consider the professional qualifications and reputation of the appraiser and obtain an understanding of the methods and assumptions used. When a valuation model, such as an option-pricing model, is used, the auditors should assess the reasonableness and appropriateness of the model and evaluate the reasonableness of the underlying assumptions. The auditors should determine that the model considers all aspects of risk, such as counterparty credit risk, risk of adverse changes in market factors, and risk of losses from legal or regulatory action.

For derivatives classified as hedges, the auditors must satisfy themselves as to the continued effectiveness of the derivative as a hedge and determine that the gains and losses from the effective and ineffective portions of the hedge are appropriately classified.

If the company has the positive intent and ability to hold marketable debt securities to maturity, they may be classified as *held-to-maturity* and valued at cost, net of any unamortized discount or premium. Nonmarketable securities also are usually valued at cost. When the cost method is used, the auditors determine the value by vouching the original purchase and recomputing any unamortized discount or premium. To determine that there is no permanent decline in value of the investment, the auditors will obtain information about its current market value.

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Illustrative Case

The Mortgage Crisis

A large number of companies, especially financial institutions, invested in mortgage-backed securities prior to 2007. A mortgage-backed security is one that represents an undivided interest in a group of mortgages. Some of these securities were guaranteed by government and private mortgage or bond insurers, such as the Government National Mortgage Association (Ginnie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and MBIA, Inc. The combination of increased interest rates, resetting of teaser (low initial) interest rates, and decline in house prices that began in the latter part of 2006 and accelerated in 2007 and 2008 resulted in significant difficulties with regard to the valuation of such securities. The market for mortgage-backed securities dried up and this led to financial difficulties, including bankruptcies and restructurings of many of the entities that guaranteed these securities. With a lack of good market data, auditors were forced to look to markets for similar securities and models that estimated fair value using discounted cash flows. In an environment of deteriorating markets and increases in default rates, it is easy to see the challenges that auditors faced with evaluating management's assertions about the fair values of these mortgage-based securities.

Investments in common stock that give the investor company the ability to exercise significant influence over operating and financial policies of the investee require use of the equity method of accounting. Ownership of 20 percent of the voting stock of an investee is used as a general indication of ability to exert influence in the absence of evidence to the contrary. Such factors as investor representation on the investee's board of directors and material intercompany transactions also suggest an ability to exercise influence.

When auditing an investment accounted for by the equity method, the auditors must verify that the investment was properly recorded initially. They also must obtain evidence regarding subsequent amounts of income from the investment and other adjustments to the investment account. This evidence is usually obtained from *audited* financial statements of the investee.

If the audited financial statements of an investee are not available for the period covered by the independent auditors' report on the investor, the auditors should perform a sufficient investigation of the investee's financial statements to determine the fairness of amounts recorded by the investor. In some cases, this might involve performing audit procedures at the investee's place of business.

If the auditors find evidence of impairment of the value of any investment, it should be written down to its net realizable value.

9. Evaluate Financial Statement Presentation and Disclosure of Financial Investments.

Auditing the presentation and disclosure of financial investments varies depending on whether a company has adopted the fair value option for valuation. If the company has *not* adopted the option, the auditors must determine that investments are properly separated into short-term and long-term portfolios. In addition, generally accepted accounting principles require the disclosure of the method of accounting for the securities and aggregate market values of the various portfolios. Disclosure also must be provided as to the amount of realized and unrealized gains and losses, as well as the allowance for market decline of both the current and long-term portfolios. Finally, the financial statements should disclose the details about debt and equity securities and derivative instruments held at year-end.

Primary Audit Objectives:
Presentation <input checked="" type="checkbox"/>

If the company adopts the fair value option, the auditors must determine that the disclosures are made in accordance with the appropriate accounting standards. The required disclosures are based largely on the manner in which the fair value hierarchy has been implemented ([Chapter 5](#) presents a discussion of the fair value hierarchy).

¹Among the accounting pronouncements on fair value are *FASB ASC 820* and *ASC 825*.

Chapter Summary

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This chapter described the fundamental controls over cash receipts and disbursements and financial investments. It also explained how the auditors design tests of controls for cash and financial investments and substantive procedures for these accounts. To summarize:

1. Since cash generally has a high degree of inherent risk, more audit time is devoted to the audit of the account than is indicated by its dollar amount.
2. Internal control over cash receipts should provide assurance that all cash received is recorded promptly and accurately. Control over cash sales is strongest when two or more employees participate in each transaction, or when a cash register or an electronic point-of-sale system controls collections. When cash receipts consist of checks received through the mail, the receipts should be listed and controlled by personnel who do not maintain cash or accounts receivable records. The control listing should be reconciled to the entries in the cash receipts journal and deposit records from the financial institution.
3. Internal control over cash disbursements is best achieved when all payments are made by check or well-controlled electronic funds transfers, except for payment of minor items from petty cash funds. Separation of the functions of preparing the payments and signing the checks tends to prevent errors and fraud in cash disbursements.
4. The principal objectives of the substantive procedures for cash are to (a) substantiate the existence of recorded cash and the occurrence of cash transactions; (b) determine the accuracy of cash transactions; (c) establish the completeness of recorded cash; (d) verify the cutoff of cash transactions; (e) determine that the client has rights to recorded cash; and (f) evaluate the adequacy of the presentation and disclosure of the cash accounts. A primary substantive procedure for cash is confirmation of the balances of the company's accounts with financial institutions.
5. The high value and liquid nature of many financial investments makes the separation of the authorization, custody, and record keeping functions especially important. In addition, securities should be registered in the name of the company; complete, detailed records of securities should be maintained; and securities should be physically inspected periodically. Derivative instruments are financial investments that may present significant risks because of the complex accounting and valuation principles that are applicable.
6. Auditors often vouch investment transactions during the year and inspect securities on hand at year-end. The liquid nature of many investments in securities makes cutoff tests especially important. Appropriate accounting for securities and derivatives is very complex and depends on the nature of the instrument and management's intent. Therefore, in auditing the valuation of certain financial investments, the auditors may use the work of a specialist, such as a security appraiser.

Key Terms Introduced or Emphasized in Chapter 10

Brokers' advice A notification sent by a stockbrokerage firm to a customer reporting the terms of a purchase or sale of securities. (410)

Check Clearing for the 21st Century Act ("Check 21 Act") This act allows financial institutions to create and process

electronic "substitute checks" in place of customer written hard-copy checks. The purpose of this act is to decrease the time for check clearing. (401)

Cutoff bank statementA bank statement covering a specified number of business days (usually 7 to 10) after the client's balance sheet date. Auditors use this statement to determine that checks issued on or before the balance sheet date and paid during the cutoff period were listed as outstanding on the year-end bank reconciliation. Another use is to determine that reconciling items shown on the year-end bank reconciliation have cleared the bank within a reasonable amount of time. (400)

DerivativesFinancial instruments that "derive" their value from other financial instruments, underlying assets, or indexes. Examples are options, forward contracts, and futures contracts. (409)
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Dividend record bookA reference book published monthly by investment advisory services reporting detailed information concerning all listed and many unlisted securities; includes dividend dates and amounts, current prices of securities, and other condensed financial data. (410)

Electronic data interchange (EDI)A computer network between companies that allows the interchange of data from one company's computer to the other's (e.g., allows purchases and sales between two firms to be processed electronically). (384)

Electronic funds transfer (EFT) systemA computer system that transmits and processes funds-related cash disbursement and receipt transactions. Increasingly, companies are electronically transferring funds between bank accounts rather than issuing checks. See also electronic data interchange. (384)

KitingManipulations causing an amount of cash to be included simultaneously in the balance of two or more bank accounts. Kiting schemes are based on the float period—the time necessary for a check deposited in one bank to clear the bank on which it was drawn. (402)

LockboxA post office box controlled by a company's bank at which cash remittances from customers are received. The bank picks up the remittances, immediately credits the cash to the company's bank account, and forwards the remittance advices to the company. (384)

Proof of cashAn audit procedure that reconciles the bank's record of cash activity with the client's accounting records for a test period. The working paper used for the proof of cash is a four-column bank reconciliation. (399)

Standard confirmation formA confirmation form, agreed to by the AICPA, the American Bankers Association, and the Bank Administration Institute, that is designed to provide corroborating evidence about the client's account balances and outstanding loans. (396)

VoucherA document authorizing a cash disbursement. A voucher usually provides space for employees to initial after they have performed approval functions. (The term voucher may also be applied to the group of documents supporting a cash disbursement.) (386)

Voucher registerA special journal used to record the liabilities for payment originating in a voucher system. The debit entries are the cost distribution of the transaction, and the credits are Vouchers Payable. Every transaction recorded in a voucher register corresponds to a voucher authorizing future payment of cash. (387)

Window dressingAction taken by the client shortly before the balance sheet date to improve the financial picture presented in the financial statements. (402)

Review Questions

- 10–1. Describe circumstances that might cause the auditors to identify understatement of assets as a significant audit risk.
- 10–2. Give two reasons audit work on cash is likely to be more extensive than might appear to be justified by the relative amount of the balance sheet figure for cash.
- 10–3. “If the auditors discover any evidence of employee fraud during their work on cash, they should extend their investigation as far as necessary to develop a complete set of facts, regardless of whether the amounts involved are or are not material.” Do you agree with the quoted statement? Explain.
- 10–4. It is sometimes said that audit work on cash is facilitated by the existence of two independent records of the client's cash transactions, which are available for comparison by the auditors. Identify these two independent records.
- 10–5. Explain how a lockbox system contributes to internal control over cash receipts.

10-6. The auditors' work on cash may include preparing a description of controls and performing tests of controls. Which of these two steps should be performed first? What is the purpose of tests of controls?

10-7. State one broad general objective of internal control over each of the following: cash receipts, cash disbursements, and cash balances.

10-8.

Among the departments of J-R Company are a purchasing department, receiving department, accounting department, and finance department. If you were preparing a flowchart of a voucher system to be installed by the company, in which department would you show:

a.

b The preparation of a check?

.

c. The signing of a check?

d The mailing of a check to the payee?

.

e. The perforation of the voucher and support?

p. 415 Describe the audit implications of the Check Clearing for the 21st Century Act.

10-9.

10-10. During your audit of a small manufacturing firm, you find numerous checks for large amounts drawn payable to the treasurer and charged to the Miscellaneous Expense account. Does this require any action by the auditor? Explain.

10-11. Prepare an example of lapping of cash receipts, showing actual transactions and the cash receipts journal entries.

10-12. During your reconciliation of bank accounts in an audit, you find that a number of checks for small amounts have been outstanding for more than a year. Does this situation call for any action by the auditor? Explain.

10-13. What information do CPAs request from a financial institution on the standard confirmation form?

10-14. How can the auditors corroborate compensating balance arrangements?

10-15. What action should be taken by the auditors when the count of cash on hand discloses a shortage?

10-16.

Explain the objectives of each of the following audit procedures for cash:

a.

b Compare paid checks returned with the balance of the previous reconciliation.

c. Trace all bank transfers during the last week of the year.

d Investigate any checks representing large amounts of cash.

- 10-17. Explain two procedures by which auditors may verify the client's cutoff of cash receipts.
- 10-18. What is the meaning of the term *window dressing* when used in connection with year-end financial statements? How might the term be related to the making of loans by a corporation to one or more of its executives?
- 10-19. An audit client that has never before invested in securities recently acquired more than a million dollars in cash from the sale of real estate no longer used in operations. The president intends to invest this money in marketable securities until such time as the opportunity arises for advantageous acquisition of a new plant site. He asks you to enumerate the principal factors you would recommend to create strong internal control over marketable securities.
- 10-20. A well-financed audit client of your CPA firm invests large amounts in marketable securities. As part of its internal control, the company uses a monthly report of securities transactions. The report is prepared by the controller and presented to the investment committee of the board of directors. What information should this report contain?
- 10-21. What information should be noted by the auditors during their inspection of securities on hand?
- 10-22. Salvador Corporation made an investment in Letter.com, Inc., in exchange for 100,000 options to purchase Letter.com's stock at \$20 per share. Since the stock options are not marketable, Salvador's management has this derivative valued by a security appraiser. The appraiser uses an option-pricing model to determine the fair value of the derivative for the financial statements. Describe how you would audit the valuation of the stock options.
- 10-23. In what ways can the audit of financial investments present special risks requiring specialized skill and knowledge?
- 10-24. How can the auditors determine that all dividends applicable to marketable securities owned by the client have been received and recorded?
- 10-25. If a security or derivative is not marketable, how do the auditors typically obtain evidence about the fair value of the instrument?

Questions Requiring Analysis

10-26.

Fluid Controls, Inc., a manufacturing company, has retained you to perform an audit

for the year ended December 31. Prior to the year-end, you begin to obtain an understanding of the new client's controls over business processes related to the cash account.

You find that nearly all the company's cash receipts are in the form of checks received through the mail, but there is no prelisting of cash receipts before they are recorded in the accounts. Also, the incoming mail is opened either by the cashier or by the employee maintaining the accounts receivable subsidiary ledger, depending on which employee has time available. The controller stresses the necessity of flexibility in assignment of duties to the 20 employees comprising the office staff, in order to keep all employees busy and achieve maximum economy of operation.

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Required:

- a Explain how prelisting of cash receipts str
 - b List specific duties that should not be perf
- in order to avoid any opportunity for that

(AICPA, adapted)

10-27.

Henry Mills is responsible for preparing checks, recording cash disbursements, and preparing bank reconciliations for Signet Corporation. While reconciling the October bank statement, Mills noticed that several checks totaling \$937 had been outstanding for more than one year. Concluding that these checks would never be presented for payments, Mills prepared a check for \$937 payable to himself, forged the treasurer's signature, and cashed the check. Mills made no entry in the accounts for this disbursement

and attempted to conceal the theft by destroying the forged check and omitting the long-outstanding checks from subsequent bank reconciliations.

Required:

a Identify the weaknesses in Signet Corpora

.

b Explain several audit procedures that might

.

10–28.

During the first few months of the year, John Smith, the cashier in a small company, was engaged in lapping operations. However, he was able to restore the amount of cash “borrowed” by March 31, and he refrained from any fraudulent acts after that date. Will the year-end audit probably lead to the discovery of his lapping activities? Explain.

10–29.

An assistant auditor received the following instructions from her supervisor: “Here is a cutoff bank statement covering the first seven business days of January. Compare the paid checks returned with the statement and dated December 31 or earlier with the list of checks outstanding at December 31.” What type of fraud might this audit procedure bring to light? Explain.

10–30.

“When auditors are verifying a client's bank reconciliation, they are particularly concerned with the possibility that the list of outstanding checks may include a nonexistent or fictitious check, and they also are concerned with the possibility of omission from the reconciliation of a deposit in transit.” Criticize the above

quotation and revise it into an accurate statement.

10-31.

In the audit of a client with a fiscal year ending June 30, the CPAs obtain a July 10 bank statement directly from the bank. Explain how this cutoff bank statement will be used:

a In the review of the June 30 bank reconciliation.

.

b To obtain other audit information.

.

(AICPA, adapted)

10-32.

In the audit of Wheat, Inc., for the year ended December 31, you discover that the client had been drawing checks as creditors' invoices became due but had not been mailing the checks immediately. Because of a working capital shortage, some checks have been held for two or three weeks.

The client's controller informs you that unmailed checks totaling \$48,500 were on hand at December 31 of the current year. He states that these December-dated checks had been entered in the cash disbursements journal and charged to the respective creditors' accounts in December because the checks were prenumbered. However, these checks were not actually mailed until early January. The controller wants to adjust the cash balance and accounts payable at December 31 by \$48,500 because the Cash account had a credit balance. He objects to submitting to his bank your audit report showing an overdraft of cash.

Discuss the propriety of adjusting the cash balance and accounts payable by

the indicated amount of outstanding checks.

10-33.

Explain how each of the following items would appear in a four-column proof of cash for the month of November. Assume the format of the proof of cash begins with bank balances and ends with the unadjusted balances per the accounting records.

a Outstanding checks at November 30.

.

b Deposits-in-transit at October 31.

.

c Check issued and paid in November, drawn

d The bank returned \$1,800 in NSF checks

. \$1,450 of these checks in November and \$350 in December. The accounting records.

10-34.

During the current year, the management of Hanover, Inc., entered into a futures contract to hedge the price of silver that will be needed for next year's production. The contract, which is held by Hanover's commodity broker, is marketable and exchanged on the Chicago Board of Trade.

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Required:

a Describe the types of controls that should be in place for silver trading.

b List the substantive procedures that the auditor should perform.

.

10-35.

During your audit of Miles Company, you prepared the following bank transfer schedule:

Check Number	Bank Accounts		Amount	-
	From	To		
2020	1st Natl.	Suburban	\$32,000	
2021	1st Natl.	Capital	21,000	1
3271	2nd State	Suburban	6,700	
0659	Midtown	Suburban	5,500	1

Required:

a.

b Identify those transfers that should be inv

.

(AICPA, adapted)

10–36.

You are the auditor in charge of the audit of Steffens Corporation. In the audit of investments, you have just been given the following list of securities held by Steffens Corporation at December 31, 20X3.

STEFFENS CORPORATION
Schedule of Marketable Securiti
December 31, 20X3

N

10,000 shares of Microsoft Corp.
6,000 shares of General Motors Corp.
8,000 shares of Beta Corporation
400 Hilton 5% Convertible Bonds

Required:

a.

b To value the shares of Beta Corporation, m

. Explain the audit considerations involved

10–37.

Multiple Choice Questions

Select the best answer for each of the following situations and give reasons for your choice.

a.

b.

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c.

d.

e.

f.

g.

h.

i.

j.

k.

l.

10–38.

Simulation

You are working on your firm's fifth audit of SSC. The previous audits have all resulted in standard unqualified audit reports. Read the following write-up from your audit files concerning SSC and its industry, and then reply to the questions that follow.

Company Information

In 20X1, Gary Sherwood founded Sherwood Stone Company (SSC). In the middle of its second year of existence, the company completed development of a large extraction pit area and constructed an aggregate processing plant that is equipped to crush, screen, and wash aggregate products. By 20X4, the sand and gravel operation was profitable and growing market conditions justified modifications and expansion.

Currently, SSC produces a wide range of sand and stone products from its pit near Bisbee, Arizona. The materials it develops are composed of sand and stone materials for commercial construction and highway projects.

SSC sells to a wide variety of

commercial and governmental customers, with only one of its numerous customers—Wingo Corporation—accounting for more than 5 percent of total sales. In total, Wingo has represented approximately 30 percent of sales (and receivables) for the past few years. Wingo Corporation is by far Arizona's largest street and road contractor and seems solid financially. Virtually all of SSC's sales are on credit, although all but the smallest contracts require “progress” billings that result in payment being received by SSC on a pro rata basis with delivery of materials to the customer. Payments from customers are made directly to the company's lockbox system with SSC's local bank. All transactions occur in U.S. dollars, and SSC maintains both a general checking account and a payroll account.

SSC has worked closely with Wingo Corporation in developing a superior road paving product (“QuietRide”). Not only is the car ride relatively quiet on QuietRide roads, but it is also relatively cool (thus lengthening the life of automobile tires) and less likely to lead to cars sliding in rainy conditions. Although Wingo Corporation holds the overall patent, SSC has patented a critical component that is used in the product (the component is “QSand”). The product now accounts for approximately 25 percent of the company's sales (all to Wingo Corporation) and 33 percent of its profits.

The success of QSand has led SSC to start developing another product, QDeck. QDeck will be a final finishing coat over the pool deck—the concrete walking and lounging area that surrounds a swimming pool. QDeck is intended to address two problems: (1) individuals slipping and falling on pool decks while walking with wet feet, and (2) individuals burning their feet on the deck on particularly hot days. Gary indicates that the current compound

seems to allow good traction and decks remain much cooler than products of other companies. The problem being addressed at this point is that the current compound seems to crack easily and has a relatively short useful life. Indeed, in one test of the product on the deck at Gary's home, Gary's wife Madonna cut her foot on one of the cracks and required several stitches to close the wound. Gary laughed and said that at least she didn't slip or burn her feet on that hot day when it happened. More seriously, he suggested that this deficiency is currently being worked on and must be solved before the product goes to market. The product is being independently developed and is intended for both residential and commercial markets.

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In 20X8, the company experienced a level of profitability just slightly above that of 20X7—but this was well below the net incomes of the preceding few years. Gary suggested to you that, surprisingly, intense price competition from several smaller competitors in the Bisbee area caused the somewhat low level of profitability. But, he added, he didn't expect the problem to last for long because he doubted that those companies could continue to operate selling at those lower prices. Gary had hoped for a more profitable year in 20X8, as a significant amount of the company's long-term debt is payable in 20X9. SSC is currently involved in discussions with the bank on refinancing.

SSC added significant additional crushing and washing plant and equipment during 20X8 to increase production in the future by more than 100 percent while expanding capabilities to produce custom specification materials.

No dividends have been paid during the past two years, although previously most of the earnings were distributed

through dividends to SSC's five shareholders—CEO and Chair of the Board of Directors Gary Sherwood, his wife Madonna Sherwood, CFO Jane Zhan, and two college friends of Gary's who invested in the company, Cindy Stone and Kelly Higgins. These five individuals make up the company's board of directors.

The Bank of Arizona is the financial institution with which SSC maintains its two cash accounts (a general and payroll cash account) and from which it obtains a significant portion of its financing; the inventories are pledged on the Bank of Arizona loan. This year, in reaction to pressure from the bank, SSC established an audit committee composed of Madonna Sherwood, Cindy Stone, and Kelly Higgins.

Industry Information

The industry activities consist of the extraction and preparation of sand and rock products. These activities include the cleaning, separating, and sorting of quarried sand and the process of crushing rocks. The products are in the form of sand used in making concrete; sand used in laying bricks (which contains little soil); sand used for fill (which contains a large amount of soil); and quartz sand. It excludes the products of gravel quarrying (sandstone, gravel stone, and iron sand).

While sales within the industry are relatively unaffected by changes in technology or obsolescence, industry sales rely heavily upon both the residential and commercial construction markets as well as government spending. During the past five years, construction has performed well and that trend is expected to continue for at least the next several years. Sand and gravel production has increased at approximately 4 percent per year during this time period, as has construction within the central Arizona area.

Questions

a.

b.

c.

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d.

e.

f.

Items *a* through *l* represent possible errors and fraud that you suspect may be present at Rex Company. The accompanying *List of Auditing Procedures* represents procedures that the auditor would consider performing to gather evidence concerning possible errors and fraud. For each item, select one or two procedures, as indicated, that the auditor most likely would perform to gather evidence in support of that item. The procedures on the list may be selected once, more than once, or not at all.

List of Auditing Procedures

A. Compare the details of the cash receipts journal entries with the details of the corresponding daily deposit slips.	L. Examine the entity's shipping documents to verify that the merchandise that produced the receivable was actually sent to the customer.
B. Scan the debits to the fixed asset accounts and vouch selected amounts to vendors' invoices and management's authorization.	M. Inspect the entity's correspondence files for indications of customer disputes for evidence that certain shipments were on consignment.
C. Perform analytical procedures that compare documented authorized pay rates to the entity's budget and forecast.	N. Perform edit checks of data on the payroll transaction tapes.
D. Obtain the cutoff bank statement and compare the cleared checks to the year-end bank reconciliation.	O. Inspect payroll check endorsements for similar handwriting.
E. Prepare a bank transfer schedule.	P. Observe payroll check distribution on a surprise basis.
F. Inspect the entity's deeds to its real estate.	Q. Vouch data in the payroll register to documented authorized pay rates in the human resources department's files.
G. Make inquiries of the entity's attorney concerning the details of real estate transactions.	R. Reconcile the payroll checking account and determine if there were unusual time lags between the issuance and payment of payroll checks.
H. Confirm the terms of borrowing arrangements with the lender.	S. Inspect the file of prenumbered vouchers for consecutive numbering and proper approval by an appropriate employee.
I. Examine selected equipment repair orders and supporting documentation to determine the propriety of the charges.	T. Determine that the details of selected prenumbered vouchers match the related vendors' invoices.
J. Send requests to confirm the entity's accounts receivable on a surprise basis at an interim date.	U. Examine the supporting purchase orders and receiving reports for selected paid vouchers.
K. Send a second request for confirmation of the receivable to the customer and make inquiries of a reputable credit agency concerning the customer's creditworthiness.	

Possible Misstatements Due to Errors and Fraud

a.

b. An auditor suspects that the controller vouchered a receivable just before year-end but did not mail the check. (Select only 1 procedure.)

p. The entity borrowed funds from a financial institution. If not recorded, the auditor suspects that the loan should be disclosed in its financial statements. (Select only 1 procedure.)

c.

d. The auditor discovered an unusually large receivable. The auditor suspects that the receivable may be uncollectible from the customer and because the auditor's initial audit of the customer. (Select only 2 procedures.)

- e. The auditor suspects that fictitious employees were paid by the payroll supervisor, who has access to payroll records. (Select **1** procedure.)
- f. The auditor suspects that selected employees were paid by the entity's payroll supervisor, who has access to payroll records. (Select **1** procedure.)
- g. The entity's cash receipts of the first few months of the year were recorded in the general operating account after the year-end. The auditor suspects that the entity recorded the cash receipts in its books during the year. (Select **1** procedure.)
- h. The auditor suspects that vouchers were prepared for merchandise that was neither sold nor returned. (Select **1** procedure.)
- i. The details of invoices for equipment repairs were recorded in the accounting department employees' vacation and sick leave records. The auditor suspects that the repairs were recorded as fixed assets. (Select **only 1** procedure.)
- j. The auditor suspects that a lapping scheme was used to conceal cash receipts. The employee who has access to cash receipts also maintains the vacation and sick leave records. (Select **only 2** procedures.)
- k. The auditor suspects that the entity is in arrears on its accounts payable by drawing a check on one account and simultaneously recording it as a debit to another account. (Select **1** procedure.)
- l. The auditor suspects that the entity's controller recorded fictitious sales to regular customers. (Select **1** procedure.)

10–40.

Simulation

Items 1 through 6 represent the items that an auditor ordinarily would find on a client-prepared bank reconciliation. The accompanying **List of Auditing Procedures** represents substantive auditing procedures. For each item, select one or more procedures, as indicated, that the auditor most likely would perform to gather evidence in support of that item. The procedures on the list may be selected once, more than once, or not at all.

Assume

- The client prepared the bank reconciliation on 12/31/X5.
- The bank reconciliation is mathematically correct.
- The auditor received a cutoff bank statement dated 12/31/X5.
- The 9/30/X5 deposit in transit—outstanding balance was \$12,000. The auditor discovered a correction of the error regarding check #1234 on 12/31/X5.
- The auditor assessed control risk concerning cash as maximum.

List of Auditing Procedures

- | | |
|--|--|
| <p>A. Trace to cash receipts journal.</p> <p>B. Trace to cash disbursements journal.</p> <p>C. Compare to 9/30/X5 general ledger.</p> <p>D. Confirm directly with bank.</p> <p>E. Inspect bank credit memo.</p> <p>F. Inspect bank debit memo.</p> <p>G. Ascertain reason for unusual delay.</p> | <p>H. Inspect supporting documents for reconciling item not appearing on cutoff statement.</p> <p>I. Trace items on the bank reconciliation to cutoff statement.</p> <p>J. Trace items on the cutoff statement to bank reconciliation.</p> |
|--|--|

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GENERAL COMPANY
Bank Reconciliation
1st National Bank of US Bank Account
September 30, 20X5

a. Select 2 Procedures	—	Balance per bank	\$ 28,375
b. Select 5 Procedures	—	Deposits in transit	
		9/29/X5	\$4,500
		9/30/X5	1,525
			6,025
			34,400
c. Select 5 Procedures	—	Outstanding checks	
		# 988 8/31/X5	2,200
		#1281 9/26/X5	675
		#1285 9/27/X5	850
		#1289 9/29/X5	2,500
		#1292 9/30/X5	7,225
			(13,450)
			20,950
d. Select 1 Procedure	—	Customer note collected by bank	(3,000)
e. Select 2 Procedures	—	Error: Check #1282; written on 9/26/X5 for \$270 was erroneously charged by bank as \$720; bank was notified on 10/2/X5	450
f. Select 1 Procedure	—	Balance per books	\$ 18,400

10–41.

Simulation

Auditors perform a number of procedures relating to cash—some unique, some not unique. For each substantive procedure below, identify its primary objective or indicate that the procedure serves no purpose.

Substantive Procedures:

- a Prepare a bank transfer schedule.
-
- b Prepare a four-column proof of cash.
-
- c Use a standard confirmation form to confirm cash.
-
- d Obtain bank cutoff statements.
-
- e Search for large checks to directors, officers, and employees.

Replies: A primary objective of the procedure is to:

1. Detect kiting.

2. Detect lapping.
3. Determine that receivables are converted to cash.
4. Establish the valuation of cash to reflect cash on hand.
5. Reconcile cash receipt and disbursement to bank statements.
6. Verify reconciling items on the year-end balance sheet.
7. Verify year-end cash and liability balances.
8. Identify related party transactions.
9. None. This procedure serves no purpose.

(AICPA, adapted)

Problems

All applicable problems are available with McGraw-Hill's *Connect™ Accounting*.



10–42.

The cashier of Mission Corporation intercepted customer A's check, payable to the company in the amount of \$500, and deposited it in a bank account that was part of the company petty cash fund, of which he was custodian. He then drew a \$500 check on the petty cash fund bank account payable to himself, signed it, and cashed it. At the end of the month, while processing the monthly statements to customers, he was able to change the statement to customer A to show that A had received credit for the \$500 check that had been intercepted. Ten days later he made an entry in the cash receipts journal that purported to record receipt of a remittance of \$500 from customer A, thus restoring A's account to its proper balance but overstating cash in the bank.

He covered the overstatement by omitting from the list of outstanding checks in the bank reconciliation two checks, the aggregate amount of which was \$500.

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Required:

Discuss briefly what you regard as the more important deficiencies in internal control in the above situation and, in addition, include what you consider a proper remedy for each deficiency.

(AICPA, adapted)

10-43.

John Harris, CPA, has been engaged to audit the financial statements of the Spartan Drug Store, Inc. Spartan is a medium-sized retail outlet that sells a wide variety of consumer goods. All sales are for cash or check. Cashiers utilize cash registers to process these transactions. There are no receipts by mail and there are no credit card or charge sales.

Required:

Construct the “Processing Cash Collections” segment of the internal control questionnaire on “Cash Receipts” to be used in the evaluation of internal control over the Spartan Drug Store, Inc. Each question should elicit either a yes or a no response. Do *not* discuss the controls over cash sales.

(AICPA, adapted)

10-44.

Following are typical questions that might appear on an internal control questionnaire for investments in marketable securities.

1. Is custody of investment securities maintained in accordance with the records of the securities?

2. Are securities registered in the company name?

3. Are investment activities reviewed by an independent auditor?

Required:

a. Describe the purpose of each of the above controls.

b. Describe the manner in which each of the above controls is implemented.

c. Assuming that the operating effectiveness of the controls is not sufficient, describe how the auditors might alter their level of control risk.

10-45.

You are the senior auditor-in-charge of the July 31, 20X0, audit of Reliable Auto Parts, Inc. Your newly hired staff assistant reports to you that she is unable to complete the four-column proof of cash for the month of April 20X0, which you instructed her to do as part of the consideration of internal control over cash.

Your assistant shows you the working paper that she has prepared. Your review of your assistant's work reveals that the dollar amounts of all the items in her working paper are correct. You learn that the accountant for Reliable Auto Parts, Inc., makes no journal entries for bank service charges or note collections until the month following the bank's recording of the item. In addition, Reliable's accountant makes no journal entries whatsoever for NSF checks that are redeposited and cleared. Your assistant's working paper appears on the next page.

Required:

Prepare a corrected four-column proof of cash in good form for Reliable Auto Parts, Inc., for the month of April 20X0.

10-46.

During the audit of Sunset Building Supply, you are given the following year-end bank

reconciliation prepared by the client:

SUNSET BUILDING SUPPLY
Bank Reconciliation
December 31

Balance per 12/31 bank statement	\$48,734
Add: Deposits in transit	4,467
	<u>\$53,201</u>
Less: Checks outstanding	20,758
Balance per ledger, 12/31	<u>\$32,443</u>

According to the client's accounting records, checks totaling \$31,482 were issued between January 1 and January 14 of the following year. You have obtained a cutoff bank statement dated January 14 containing paid checks amounting to \$50,440. Of the checks outstanding at December 31, checks totaling \$3,600 were not returned in the cutoff statement, and of those issued per the accounting records in January, checks totaling \$8,200 were not returned.

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RELIABLE AUTO PARTS, INC.
Proof of Cash for April 20X0
July 31, 20X0

	Balance 3/31/X0	Deposits	Checks	Balance 4/30/X0
Per bank statement	\$ 71,682.84	\$61,488.19	\$ 68,119.40	\$ 65,051.63
Deposits in transit:				
At 3/31/X0	2,118.18			(2,118.18)
At 4/30/X0		4,918.16		4,918.16
Outstanding checks:				
At 3/31/X0	(14,888.16)		14,888.16	
At 4/30/X0			(22,914.70)	22,914.70
Bank service charges:				
March 20X0	(22.18)		22.18	
April 20X0			(19.14)	19.14
Note receivable collected by bank 4/30/X0		18,180.00		18,180.00
NSF check of customer L. G. Waite, charged back by bank 3/31/X0, redeposited and cleared 4/3/X0	(418.19)	418.19		
Balances as computed	<u>58,472.49</u>	<u>85,004.54</u>	<u>60,095.90</u>	<u>108,964.45</u>
Balances per book	<u>59,353.23</u>	<u>45,689.98</u>	<u>76,148.98</u>	<u>28,894.23</u>
Unlocated difference	<u>\$ (880.74)</u>	<u>\$39,314.56</u>	<u>\$(16,053.08)</u>	<u>\$ 80,071.22</u>

Required:

a.

- b Suggest four possible explanations for the
 . action you would take in each case, includ

10-47.

MLG Company's auditor received confirmations and cutoff statements with related checks and deposit tickets for MLG's three general-purpose bank accounts directly from the banks. The auditor has assessed control risk for the assertions about cash as low. The proper cutoff of external cash receipts and disbursements was established. No bank accounts were opened or closed during the year.

Required:

Prepare the audit program of substantive procedures to verify MLG's bank balances. Ignore any other cash accounts.

(AICPA, adapted)

In-Class Team Cases

10-48.

Listed below are eight interbank cash transfers for Steven Smith Co., indicated by the letters *a* through *h*, for late December 20X1 and early January 20X2.

	Disbursing Bank (Month/Day)		Receiving Bank (Month/Day)		Amount
	Per Bank	Per Books	Per Bank	Per Books	
a.	12/29	12/29	12/29	12/29	\$52,000
b.	1/02	12/30	12/31	12/30	16,000
c.	1/04	12/31	1/02	1/02	24,000
d.	1/04	12/31	1/02	12/31	44,000
e.	1/04	1/01	1/03	1/01	15,600
f.	1/02	1/01	12/31	12/31	76,000
g.	1/03	1/02	12/31	1/02	42,000
h.	12/31	1/03	12/30	1/03	10,000



For each of the transfers *a* through *h*, (1) indicate whether cash is *understated*, *overstated*, or *correct* as a result of the transfer; and (2) provide a brief example of what could cause the situation. Answer in a form such as the one illustrated here.

Transfer	Understated, Overstated, or Correct	Example
a.	Correct	<i>Book entries:</i> The transfer was recorded in the accounting records as a check written on the disbursing bank on December 29 and a corresponding cash receipt recorded to receiving bank on that date. <i>Bank entries:</i> The check was taken to the receiving bank on December 29 and deposited. The accounts are both in the same bank, and accordingly the transaction was recorded in both accounts as of that date.
b.		
⋮		
h.		

10–49.

An improper cutoff of transactions around year-end occurs when journal entries are recorded in the wrong year. In this case, you are to determine the effects of various cutoff misstatements relating to recording cash receipts received on accounts receivable and the recording of credit sales. To effectively consider the effects of an improper cutoff, it is helpful to consider the underlying journal entries:

Type of Transaction	Proper Journal Entry (Entries)
<i>Cash receipt on an account receivable</i>	Cash 3,000.00 Accounts Receivable 3,000.00
<i>Credit sale—periodic inventory system</i>	Accounts receivable 2,000.00 Sales 2,000.00
<i>Credit sale—perpetual inventory system</i>	Accounts receivable 2,000.00 Sales 2,000.00 Cost of Goods Sold 1,300.00 Inventory 1,300.00

An example of a possible improper cutoff is to “close” the cash receipts journal on December 30 and include December 31 sales in the subsequent year (e.g., the entry is dated January 1 rather than December 31). As a result, cash is understated by \$3,000, while accounts receivable is overstated by \$3,000 for the year just ended. The effects of closing the sales journal depend upon whether a periodic inventory or perpetual inventory system is in use. The effects of “leaving open” journals past year-end and dating January entries as of December may be determined in a similar manner.

Required:

Assume that the client made the following actual credit sales and received cash receipts as follows after 12/29/20X8:

	Sales	Cost of Goods Sold	Cash Receipts (Receivables Collected)
12/30/X8	\$1,000	\$ 600	\$4,000
12/31/X8	2,000	1,300	3,000
1/1/X9	3,500	2,200	2,500
1/2/X9	4,000	2,900	3,200

Determine the overstatements and understatements that would result from the following situations. Assume that each situation is independent of one another. As an illustration, situation 1 has been solved for you. To simplify the problem, in the case of a perpetual inventory, assume that the year-end inventory count did not identify and correct the misstatement(s).

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Situation	Cash	Acct. Rec.	Inventory	CGS	Sales	Income
1. Zhang Inc. left the cash receipts journal open after year-end for an extra day and included January 1 cash receipts in the December 31 totals. The company uses a periodic inventory system. What effect would this have on 20X8?	\$2,500 (o)	\$2,500 (u)				
2. Zhang Inc. closed the cash receipts journal at 12/29 and reported the last two days of cash receipts in January of 20X9. The company uses a periodic inventory system. What effect would this have on 20X8?						
3. Zhang Inc. left the sales journal open after year-end for an extra day and included January 1 sales in the December 31 totals. The company uses a periodic inventory system. What effect would this have on 20X8?						
4. Same as 3, but the company uses a perpetual inventory system.						
5. Zhang Inc. closed the sales journal at 12/29 and reported the two last days' sales in January of 20X9. The company uses a perpetual inventory system. What effect would this have on 20X8?						
6. Zhang Inc. left both the sales journal and the cash receipts journal open through January 2 and reported the first two days' transactions in December of 20X8. The company uses a periodic inventory system. What effect would this have on 20X8?						

Research and Discussion Case

10–50.

On October 21, Rand & Brink, a CPA firm, was retained by Suncraft Appliance Corporation to perform an audit for the year ended December 31. A month later, James Minor, president of the corporation, invited the CPA firm's partners, George Rand and Alice Brink, to attend a meeting of all officers of the corporation. Mr. Minor opened the meeting with the following statement:

“All of you know that we are

not in a very liquid position, and our October 31 balance sheet shows it.” We need to raise some outside capital in January, and our December 31 financial statements (both balance sheet and income statement) must look reasonably good if we're going to make a favorable impression upon lenders or investors. I want every officer of this company to do everything possible during the next month to ensure that, at December 31, our financial statements look as strong as possible, especially our current position and our earnings.

“I have invited our auditors to attend this meeting so they will understand the reason for some year-end transactions that might be a little unusual. It is essential that our financial statements carry the auditors' approval, or we'll never be able to get the financing we need. Now, what suggestions can you offer?”

The vice president for sales was first to offer suggestions: “I can talk some of our large customers into placing some orders in December that they wouldn't ordinarily place until the first part of next year. If we get those extra orders shipped, it will increase this year's earnings and also increase our current assets.”

The vice president in charge of production commented: “We can ship every order we have now and every order we get during December before the close of business on December 31. We'll have to pay some overtime in our shipping department, but we'll try not to have a single unshipped order on hand at year-end. Also, we could overship some orders, and the customers wouldn't make returns until January.”

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The controller spoke next: “If there

are late December orders from customers that we can't actually ship, we can just label the merchandise as sold and bill the customers with December 31 sales invoices. Also, there are always some checks from customers dated December 31 that don't reach us until January—some as late as January 10. We can record all those customers' checks bearing dates of late December as part of our December 31 cash balance.”

The treasurer offered the following suggestions: “I owe the company \$50,000 on a call note I issued to buy some of our stock.” I can borrow \$50,000 from my mother-in-law about Christmas time and repay my note to the company. However, I'll have to borrow the money from the company again early in January, because my mother-in-law is buying a condo and will need the \$50,000 back by January 15.

“Another thing we can do to improve our current ratio is to write checks on December 31 to pay most of our current liabilities. We might even wait to mail the checks for a few days or mail them to the wrong addresses. That will give time for the January cash receipts to cover the December 31 checks.”

The vice president of production made two final suggestions: “Some of our inventory, which we had tentatively identified as obsolete, does not represent an open-and-shut case of being unsalable. We could defer any write-down until next year. Another item is some machinery we have ordered for delivery in December. We could instruct the manufacturer not to ship the machines and not to bill us before January.”

After listening to these suggestions, the president, James Minor, spoke directly to Rand and Brink, the auditors. “You can see I'm doing my best to give you full information and cooperation. If any of these suggested

actions would prevent you from giving a clean bill of health to our year-end statements, I want to know about it now so we can avoid doing anything that would keep you from issuing an unqualified audit report. I know you'll be doing a lot of preliminary work here before December 31, but I'd like for you not to bill us before January. Will you please give us your reactions as to what has been said in this meeting?"

Required:

- a Put yourself in the role of Rand & Brink, meeting. What general term is applicable?
- b Could you assure the client that an unqualified audit opinion would be issued if all the matters discussed were followed on all the matters discussed?
- c Would the discussion in this meeting cause you to change your opinion?

Ethics Case

10-51.

Today you had lunch with your friend Sarah Teasdale. Sarah has worked with Zaird & Associates, CPAs, for about two years. You've been with Zaird for only nine months. You discussed with her your difficulties in getting jobs done in the budgeted number of hours. Sarah said, "Yeah, that's a problem. You'll get quicker with experience, but—don't tell anyone I told you this—some of those audit programs are pretty awful and include some pretty outdated and even some stupid procedures." Sometimes I just sign the program, but skip doing the procedure. "I don't do this often, but sometimes the procedure isn't capable of detecting anything." You said little to her after this, but are now thinking about whether you need to become more "practical" about

how you perform your work.

Required:

a Identify your problem here.

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b Identify your possible courses of action. For each course of action, identify the decision (e.g., personal standards, societal standards, professional standards), and analyze the consequences.

c Select the best course of action.