Chapter 17–Auditing the Investing and Financing Cycles

The Investing Cycle

This pertains to activities relating to ownership of securities issued by other entities. The types of instruments included are: certificates of deposit, preferred and common stocks, and bonds. The investing cycle interfaces with cash receipts and disbursements transactions. Let us consider some definitions.

Investing activities—the purchase and sale of land, buildings, equipment, and other assets not generally held for resale. These activities also include the purchase and sale of financial instruments not intended for trading.

The auditor must ask what assets are needed to support an entity’s operations and when assets were acquired during a period.

Financing activities—include transactions and events whereby cash is obtained from or repaid to creditors or owners. Financing activities would include acquiring debt, capital leases, issuing bonds or stock. These activities also include retiring debt, buying treasury stock and payment of dividends.

Materiality, Risk, and Audit Strategy

It is crucial that an auditor obtain an intimate understanding of the client’s business and industry. There can be a sizable variation between industries in the importance of financing and investing activities. Industry knowledge is important for developing expectations with regard to financial statement line items.

Please take note of the account balance and transaction class audit objectives for the financing cycle in Fig. 17-2 on page 740.

The primary criterion in evaluating the allocation of materiality is the determination of the magnitude of misstatement that will influence the decisions of a reasonable financial statement user. Usually but not always the auditor will allocate less materiality to fixed assets.

In the case of the investing cycle, inherent risk is influenced by:
Inherent risk may be increased because of the potential that scrapped or retired assets may not be written off.

Figure 17-3 lists some analytical procedures that can be useful in identifying potential problems with plant assets.

One key transaction that an auditor should focus on is the initial accounting for the acquisition of plant assets.

Control risk should be low for the acquisition of fixed assets with regard to the E or O assertion due to the existence of capital budgets and B of D authorization.

**Substantive Tests of Plant Asset Balances**

Figure 17-4 contains a list of substantive tests of plant assets and the associated audit objectives. You should be familiar with these.

Auditing information on the beginning balances for plant assets is one of the largest risks in an initial engagement. You may need to look at transactions that happened in years past.

**Initial Procedures**

As auditor, you must be sure that the starting G/L balance for plant assets agrees with the prior year’s working papers. Also, you should test the mathematical correctness of client-prepared schedules of additions and disposals and reconcile the totals with the changes in the related G/L balances for plant assets. Also, the auditor should vouch items on the schedules to entries in the G/L and tracing ledger entries to the schedules to determine they are an accurate representation of the accounting records.

**Tests of Details of Transactions**

All major additions to plant assets should be supported by documentation in the form of authorizations in the minutes, vouchers, invoices, contracts, and canceled checks. The vouching of additions provides evidence about the E or O, R and O, and V or A assertions.
Evidence of sales, retirements, and trade-ins should be available to the auditor in the form of cash remittance advices, written authorizations, and sales agreements. The following procedures may also be useful to determine whether all retirements have been recorded:

The auditor should also review entries to repairs and maintenance expense to determine the propriety and consistency of the charges to repairs expense. The client must make the appropriate distinction between capital and revenue expenditures. This concerns the completeness assertion for plant assets.

**Tests of Details of Balances**

There are various procedures or substantive tests that should be considered. These are:

1. Inspect plant assets

2. Examine title documents and contracts

3. Tests of accounting estimates for depreciation and asset impairment

**The Financing Cycle**

The two major transaction classes in the financing cycle are long-term debt
transactions and stockholders’ equity transactions. The financing cycle interfaces with
the expenditure cycle when cash is disbursed for bond interest, the redemption of
bonds, cash dividends, and the purchase of treasury stock.

Figure 17-6 lists specific account balance and transaction class audit objectives
related to the financing cycle. Please familiarize yourself with these.

Materiality, Risk, and Audit Strategy

The importance of long-term debt to the fair presentation of the financial
statements varies considerably. From an inherent risk standpoint, the risk of
misstatements in executing and recording financing cycle transactions is low.

Figure 17-7 presents some analytical procedures that may identify problems in
the financing cycle accounts for the auditor.

You should be familiar with the common documents and records and functions
and related controls listed on pages 753 and 754.

Substantive Tests of Long-Term Debt Balances

Figure 17-8 on page 766 involves a list of possible substantive tests of L-T debt
balances along with the audit objectives to which each test relates. The auditor’s main
concern is understatement (completeness assertion).

Initial Procedures

The schedules associated with long-term debt may include separate schedules
on L-T notes payable, obligation under capital leases, and listings of registered bond
holders. These procedures relate to the mathematical and clerical accuracy component
of the V or A assertion.

Tests of Details of Transactions

For bonds, evidence should be obtained on the face value and net proceeds of
bonds. Vouchers and canceled checks can be examined to verify principal payments.
Vouching of entries to long-term debt accounts gives evidence for these assertions: E or
O, Completeness, R and O, and V or A.

Tests of Details of Balances

Review Authorizations and Contracts

These should be found in the B of D meeting minutes. Reviews of contracts
should include details of various covenants and compliance therewith and obligations
under capital leases.

Confirm Debt

The auditor should have direct communication with lenders and bond trustees to confirm the existence and terms of L-T debt. All confirmations should be compared with the records and any differences should be investigated.

Recalculate Interest Expense

Interest payments are traced to supporting vouchers, canceled checks, and confirmation responses.

Substantive Tests of Stockholders’ Equity Balances

The V or A and P and D assertions involve maintaining the distinction between paid-in capital and retained earnings.

Determining Detection Risk

Inherent and control risk assessments are low for account balance assertions when routine stock transactions are handled by a registrar and transfer agent.

Designing Substantive Tests

Substantive tests and audit objectives are shown in Figure 17-10.

Initial and Analytical Procedures

Those procedures outlined in Fig. 17-10 relate to the mathematical and clerical accuracy element of the V or A assertion.

Figure 17-11 presents several ratios that can point out problems in the owners’ equity accounts.

Tests of Details of Transactions

Vouch Entries to Paid-In Capital Accounts

Each change in a capital stock account should be vouched to supporting documentation. If consideration for shares was other than cash, the auditor should carefully examine the basis for the valuation.

Vouch Entries to Retained Earnings

Each entry to retained earnings except the posting of net income should be
vouched to supporting documentation. Entries for dividend declarations and retained earnings appropriations are traced to the minutes book. Vouching enables the auditor to ascertain whether

The auditor should trace dividend payments to canceled checks and other documents. Also, the auditor should establish the number of shares outstanding on the date of record and verify the accuracy of the total dividend declaration by recalculation.

Tests of Details of Balances

Review Articles of Incorporation and By-Laws

This review is primarily a concern in the initial audit. Key matters found in the articles and/or by-laws should be noted in the working papers. The review is also used to determine whether the B of D has been acting within the scope of its authority.

Review Authorizations and Terms of Stock Issues

This is a substantive test that relates to the E or O and R and O assertions.

Confirm Shares Outstanding with Registrar and Transfer Agent

When the client uses a registrar, the auditor should confirm total shares authorized, issued, and outstanding at the balance sheet date with the registrar.

Inspect Stock Certificate Book

This test is required when the client serves as its own transfer agent.

Inspect Certificates of Shares Held in Treasury

This test pertains to the E or O, Completeness, and R and O assertions.