Chapter 18–Auditing Investments and Cash Balances

General Considerations

Cash balances include undeposited receipts on hand, cash in bank in unrestricted accounts, and impress accounts such as petty cash and payroll bank accounts. The five transaction cycles which relate directly to general cash balances are revenue, expenditure, financing, investing, and personnel services.

This chapter relates primarily to substantive tests for cash balances. Hence, the account balance audit objectives shown in Fig. 18-5 are those for cash:

E or O—did recorded cash balances exist at the balance sheet date/

Completeness—are the effects of all cash transactions included in cash?

Are year-end account transfers recorded in the proper period?

R and O—does the client have legal title to all cash shown on the balance sheet?

V or A—does cash on the balance sheet match supporting schedules?

P and D—are cash balances properly classified?

Are lines of credit, loan guarantees, compensating balance agreements, and other restrictions disclosed properly?

Materiality, Risk, and Audit Strategy

Key point–the high volume of transactions that go through cash creates a high level of inherent risk for the E or O and completeness assertions. Auditors tend to conduct an extensive amount of substantive tests on cash.

Substantive Tests of Cash Balances

Determining Detection Risk

The nature, timing, and extent of substantive tests on cash can be varied extensively to be commensurate with varying risk levels. Auditors need to consider control risk assessments for cash receipts and disbursements in each cycle in addition to inherent risk.

Substantive Tests Design

Let's consider Fig. 18-6 as it contains many substantive tests of cash balance assertions.

Initial Procedures

Tracing the current period's starting balances to the ending audited balances in the prior year's working papers is the starting point for verifying cash balances. Second, the auditor should review the current period's activity in the G/L cash accounts for unusual entries. Client summaries of undeposited cash receipts should be analyzed.

Analytical Procedures

Various cash ratios should be computed and analyzed for signals of possible manipulation. Such an analysis can provide evidence for the E or O, completeness, and V or A assertions.

Tests of Details of Transactions

Perform Cash Cutoff Tests

A proper cutoff of cash receipts and disbursements at year end is vital to the proper statement of cash at the balance sheet date. Two cash cutoff tests to perform are a cash receipts cutoff test and a cash disbursements cutoff test. The assertions addressed are E or O and completeness.

Trace Bank Transfers

Many entities maintain accounts with more than one bank. Thus, an entity may transfer money between banks. A transfer usually involves float. Cash on deposit per bank records will be overstated during the float period because the check will be included in the balance of the bank in which it is deposited and will not be deducted from the bank on which it is drawn.

Intentionally recording a bank transfer as a deposit in the receiving bank while failing to show a deduction from the bank account on which the transfer check is drawn is **kiting.**

Auditors prepare a bank transfer schedule as evidence of the validity of bank transfers or of misstatements therein. Data for the schedule are obtained from an analysis of the cash entries per books and applicable bank and cutoff bank statements. Consider Fig. 18-7 in your textbook.

Kiting is possible when internal control weaknesses permit one person to issue and record checks or collusion exists between the two people who are responsible for the two functions. Kiting may be detected by obtaining and using a bank cutoff statement because a kited check clearing in January will not appear on the list of outstanding checks for December and performing a cash cutoff test because the last check issued in December will not be recorded in the check register.

Prepare a Proof of Cash

A proof of cash is

A proof of cash permits a reconciliation of four bank and book items: beginning balances, cash receipts transactions, cash disbursements transactions, and ending cash balances. Fig. 18-A1 shows one example of a proof of cash working paper.

Tests of Details of Balances

We need to consider five commonly used substantive tests of cash balances:

1–Count Cash on Hand

The auditor needs to do the following to properly perform a cash count:

This test provides evidence about each of the five financial statement assertions except P & D.

2–Confirm Bank Deposit and Loan Balances

It is customary for the auditor to obtain a bank confirmation for cash on deposit and loan balances at the balance sheet date. Take a look at Fig. 18-6. Bank confirmation requests should be sent to all banks in which the client has an account, including those that may have a zero balance. The confirmation of cash provides evidence for the following two assertions:

The confirmation of loan balances provides evidence for the following three assertions:

1-existence or occurrence because there is written acknowledgment that the loam balance exists
2-rights and obligations because the loan is a debt of the client
3-valuation or allocation because the response indicates the amount of the loan balance

3–Confirm Other Arrangements with Banks

Some borrowers must maintain a compensating balance as part of a credit facility or loan arrangement with a bank. Also, a contingent liability may exist when the client is the guarantor of a loan made by the bank to a third party. Any confirmation sent to a financial institution concerning a compensating balance or guaranty should be signed by the client.

4–Scan, Review, or Prepare Bank Reconciliations

When the acceptable level of detection risk is high, the auditor may scan the client-prepared bank reconciliation and verify the mathematical accuracy of the reconciliation. If detection risk is moderate, the auditor may review the client's bank reconciliation. The review will usually include:

–Comparing the ending bank balance with the balance confirmed on the bank confirmation form
–Verifying the validity of deposits in transit and outstanding checks
–Establishing the mathematical accuracy of the reconciliation

–Vouching reconciling items such as bank charges and credits and errors to supporting documentation

–Investigating old items such as checks outstanding for a long period of time and unusual items

When detection risk is low, the auditor may prepare the bank reconciliation using bank data in the client's possession. When the auditor suspects material misstatements, the auditor may obtain bank statements directly from the bank and prepare the bank reconciliation.

5–Obtain and Use Bank Cutoff Statements

A bank cutoff statement is a bank statement as of a date subsequent to the date of the balance sheet. The date should be at a point in time that will permit most of the year-end outstanding checks to clear the bank. The client must request the cutoff statement from the bank and instruct that it be sent directly to the auditor. Once in hand, the auditor should:

The tracing of checks is designed to verify the list of outstanding checks. If the auditor finds that a prior-period check not on the list of outstanding checks has cleared the bank then kiting may be present.

When the aggregate effect of uncleared checks is material, it may be a sign of window dressing. This is usually an intentional attempt by management to make the firm's solvency appear better than it actually is. Here the auditor should trace the uncleared checks to the check register and supporting documentation and possibly make inquiries of the treasurer.

Other Considerations

Tests to Detect Lapping

Lapping is an irregularity that results in the deliberate misappropriation of cash receipts. Lapping is usually associated with collections from customers, but it may also involve other types of cash receipts. Conditions conducive to lapping exist when an individual who handles cash receipts also maintains the A/R ledger.

Auditing Procedures

Tests to detect lapping are only performed when control risk for cash receipts transactions is moderate or high. Three main procedures are available to detect lapping:

1-confirm A/R–it must be done on a surprise basis at an interim date to be effective

2–make a surprise cash count–the auditor should oversee the deposit of coin, currency, and checks. The details of the deposit shown on the duplicate deposit slip should be compared with the cash receipts journal entries and postings to customer accounts.

3–compare details of cash receipts journal entries with the details of corresponding daily deposit slips