CHAPTER 10

Cash and Financial Investments

Management Assertions

When auditors test cash, what management assertion/s are they MOST interested in?

- **Existence**
  - YES, but remember “conservatism”

- **Completeness**
  - YES, MAYBE IT IS “restricted”

- **Rights & Oblig.**
  - Probably not

- **Valuation**
  - Yes, MAYBE IT IS “restricted”

- **Presentation & discl.**
  - Yes, if restricted, need to present and disclose as such

CASH CONTROLS

Generally two broad categories:

1. Cash receipts
2. Cash disbursements

Cash Controls

Why are cash controls important?
- Cash is most susceptible asset to theft.
- Because ultimately everything culminates in cash, consequently other problems frequently manifest themselves as unknown “reconciling items” when the bank reconciliation is performed.

What do you think are the two most important cash controls to have?
- Segregation of duties (forces collusion)
- Check signing authority (have to get the cash out of the bank in order to steal it)
Internal Control Over --Cash Receipts

- Cash sales
  - Involvement of two or more employees
  - Cash Registers
  - Electronic point of sales systems
- Collections of receivables
  - Initial listing of cash receipts
  - Custody and depositing of cash receipts
  - Maintenance of customer account records
  - Reconciliation of customers' ledgers with control accounts
  - Mailing monthly statements to customers
  - Collection activity and past-due accounts

Potential Misstatements--Cash Receipts

- Recording fictitious cash receipts
- Failure to record receipts from cash sales
- Failure to record cash from collection of accounts receivables
- Early (late) recognition of cash receipts

CAYN BE ANYTHING IN THERE!
- Bank reconciliation will pick it up
  - That's why I have always viewed the bank rec. as a critical item to an audit.
  - I have found lots of errors and irregularities via review of the bank reconciliation. It's an underrated item in my humble opinion.

Internal Control--Cash Disbursements

- Segregation of duties
- Payment by check or electronic funds transfer
- Match of purchase order and receiving documents with vendor's invoice
- Review of supporting documents by authorized check signer
- Cancel of supporting documents
- Authorized check signer should mail checks
- Don't pay an unauthorized vendor/ vendor approval process
- Bank involvement

Objectives for the Audit Cash

- Consider the inherent risks related to cash, including fraud risks
- Consider internal control over cash transactions
- Substantiate the existence of recorded cash
- Establish the completeness of recorded cash
- Determine that the client has rights to recorded cash and has made a proper Cutoff
- Establish the clerical accuracy of cash schedules
- Determine that the presentation and disclosure of cash, including restricted funds, are appropriate
**Substantive Tests for Cash Balances**

- Obtain analyses of cash balances and reconcile to general ledger
- Send standard confirmation forms to financial institutions
- Obtain reconciliations of bank balances and consider reconciling bank activity (need a bank statement)
- Obtain bank cutoff statement
- Count cash on hand (only if material)
- Verify the client’s cutoff of cash transactions
- Analyze bank transfers occurring around year-end
- Investigate payments to related parties
- Evaluate financial statement presentation and disclosure

**Illustration of Schedule of Bank Transfers to Detect Kiting**

<table>
<thead>
<tr>
<th>Check No.</th>
<th>Bank Accounts</th>
<th>Date of Disbursement</th>
<th>Date of Receipt</th>
</tr>
</thead>
<tbody>
<tr>
<td>5897</td>
<td>General Payroll</td>
<td>12/28</td>
<td>12/28</td>
</tr>
<tr>
<td>6006</td>
<td>General Branch 4</td>
<td>12/30</td>
<td>12/30</td>
</tr>
<tr>
<td>6029</td>
<td>Branch 2 General</td>
<td>1/3</td>
<td>1/5</td>
</tr>
</tbody>
</table>

**Management Assertions**

When auditors test INVESTMENTS, what management assertion/s are they MOST interested in? **Existence & Valuation** if recorded at fair value? **WHAT ABOUT THE OTHERS:**

- Completion: YES, but remember "conservatism"
- Rights & Oblig.: YES, MAYBE IT IS "restricted"
- Presentation & disc.: YES, if restricted, need to present and disclose as such

**Objectives for the Audit of Financial Investments**

- Consider the **inherent risks**, including fraud risks
- Consider **internal control** over financial investments
- Determine the **existence** of recorded financial investments and that the client has **rights** to the investments
- Establish the **completeness** of recorded financial investments
- Determine that the **valuation** of financial investments is in accordance with **GAAP**
- Establish the **clerical accuracy** of schedules of investments
- Determine that the **presentation and disclosure** of financial investments are appropriate
Controls Over Financial Investments

- Establishment of formal investment policies
- Review and approval of investment activities by the investment committee of the board of directors
- Separation of duties among employees
- Authorizing purchases and sales
- Having custody of the securities
- Maintaining records
- Detailed records of all securities owned and the related revenue from interest and dividends
- Registration in the name of the company
- Periodic physical inspection of securities
- Determination of accounting for complex instruments by competent personnel

Potential Misstatements--Financial Investments

- Misstatement of recorded value of investments
- Unauthorized investment transactions
- Incomplete recording of investments
- Inadequate disclosure of the nature of investment activities

Considerations in Auditing Derivatives and Securities

- Specialized skills may be needed to evaluate:
  - Information systems
  - Service organization controls
  - Application of complex accounting principles
  - Estimates of fair values
  - Inherent and control risks for speculation and hedging activities

Considerations in Auditing Derivatives and Securities—Cont.

- May present the entity with a high degree of business risk (e.g., risk of losses)
- May involve complex accounting and valuation methods
- Rules for maintaining acquiring and maintaining a derivative as a hedge are complex
- May be difficult to identify because they may be acquired without an outlay of assets until a future date
Substantive Tests of Financial Investments

- Obtain an analysis of investment and related accounts and reconcile to ledger
- Inspect securities on hand and review agreements underlying derivatives
- Confirm securities and derivative instruments held by others
- Vouch selected investment transactions, and verify the client's cutoff of investment transactions
- Review investment committee minutes and reports
- Perform analytical procedures
- Compute revenue from securities
- Inspect management's documentation of intent to classify derivative transactions as hedges
- Evaluate method of accounting for investments
- Test valuation of investments
- Evaluate the financial statement presentation and disclosure