18 AUDITING INVESTMENTS AND CASH BALANCES

WHERE'S THE CASH? AUDITOR'S UNCOVER MASSIVE FRAUD

From August 2003 through November 2003, Parmalat Finanziaria, S.p.A. (Parmalat), an Italian milk products company, offered $100 million of unsecured Senior Guaranteed Notes to U.S. investors. The $100 million note offering failed after Parmalat's auditors raised questions about certain Parmalat accounts.

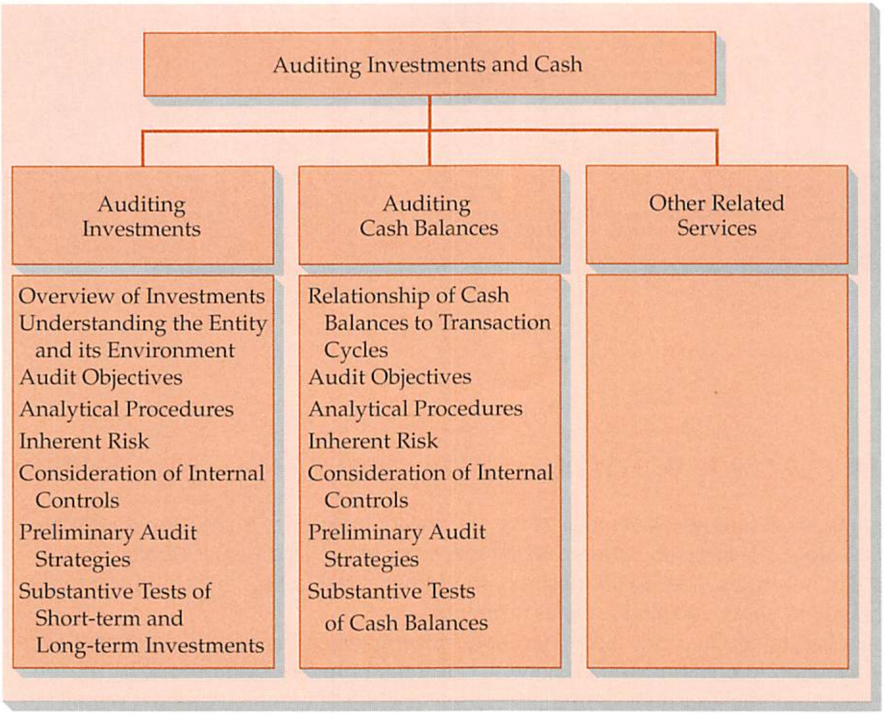
Massive fraudulent financial reporting was uncovered when Parmalat's auditors sent a bank confirmation to confirm cash on hand at the Bank of America and the bank replied that there was no such account. In the previous financial statements Parmalat purported to hold approximately $4.9 billion of cash and marketable securities at the Bank of America in New York City in the name of Bonlat Financing Corporation, a wholly owned subsidiary incorporated in the Cayman Islands. Bonlat's auditors certified the subsidiary's 2002 financial statements were based upon a false confirmation that Bonlat held these assets at the Bank of America. However, the bank account did not exist, and the bank confirmation upon which Bonlat's auditors relied had been forged.

It subsequently came to light that Parmalat overstated cash and marketable securities by at least 2.4 billion Euros for the year ended 2002 and by at least 2.95 billion Euros for the year ended 2003. This chapter explores audit procedures that are normally used to audit investments and cash balances. Some of these procedures eventually brought this massive fraud to public scrutiny.

Sources: Accounting and Auditing Enforcement Release 1936, December 30, 2003, and Accounting and Auditing Enforcement Release 2065, July 28, 2004.

[PREVIEW OF CHAPTER 18]

This chapter focuses on the audit of two very liquid assets: investments in marketable securities and cash balances. This chapter completes the discussion of investing activities, begun in Chapter 17, with an examination of an entity's investments in securities. This discussion centers on entities other than those in the financial services sector (where investments in the securities of other companies are core operating activities). Finally, the chapter discusses the audit of cash balances, which result from the cumulative effects of the revenue, expenditure, production, personnel, investing, and financing cycles. Attention is also given to two types of fraud involving cash—*kiting,* which involves interbank transfers, and *lapping,* which involves misappropriating cash receipts. The following diagram provides an overview of the chapter organization and content.



Chapter 18 focuses on the following aspects of the auditor's decision process associated with auditing investment and cash balances.

focus on audit decisions

After studying this chapter you should understand the factors that influence the following audit decisions.

D1. What is the nature of short-term and long-term investments, and how are specific audit objectives developed for short-term and long-term investments?

D2. What audit planning decisions should be made when developing an audit program for the audit of short-term and long-term investments?

D3. What factors are involved in determining an acceptable level of tests of details risk for short-term and long-term investments?

D4. How does the auditor determine the elements of an audit program for substantive tests to achieve specific audit objectives for short-term and long-term investments?

D5. What is the relationship of the transaction cycles to cash balances, and how are specific audit objectives developed for cash balances?

D6. What audit planning decisions should be made when developing an audit program for the audit of cash balances?

D7. What factors are involved in determining an acceptable level of tests of details risk for cash balance assertions?

D8. How does the auditor determine the elements of an audit program for substantive tests to achieve specific audit objectives for substantive tests for cash balances?

D9. What is the fraud known as kiting, and how can the auditor detect it?

D10. What is the fraud known as lapping, and how can the auditor detect it?

D11. What are the roles of confirmations and the use of a bank cutoff statement in the audit of cash balances?

D12. How might the auditor use the knowledge obtained during the audit of investments and cash balances to deliver other services to clients?

AUDITING INVESTMENTS

OVERVIEW OF INVESTMENTS

Audit Decision 1

■ What is the nature of short-term and long-term investments, and how are specific audit objectives developed for short-term and long-term investments?

On June 30, 2004, Microsoft reported total cash and short-term investments of $60.52 billion. Microsoft reports that the short-term investments are generally in liquid, investment-grade securities. Although Microsoft had an unusually high proportion of investments for a company that is not in the business of trading securities, many companies make similar investments while they are waiting to invest excess cash in other forms of productive assets. An entity's investment activities represent activities relating to the ownership of securities issued by other entities. These securities include certificates of deposit (CDs), preferred and common stocks, and corporate and government bonds. This chapter focuses on investments in common stock and corporate bonds.

Investing in marketable securities interfaces with two other cycles. Dividends and interest received on investments involve cash receipts transactions discussed in this text as part of the revenue cycle. A purchase of securities with cash involves cash disbursements transactions discussed in this text as part of the expenditure cycle. These transactions may be subjected to the same controls as other cash receipts and disbursements transactions as discussed in Chapters 14 and 15, as well as additional controls applicable only to **investing transactions** as discussed in later sections.

The following accounts are used in recording short-term and long-term investing transactions and the resulting income statement effects of those investments:

Balance Sheet Accounts	Income Statement Accounts
Investments in equity and debt securities classified as trading or available-for-sale securities	Dividend revenue (from equity investments not accounted for by the equity method)
Market adjustment accounts for the above asset accounts (when there is an accumulated difference between cost and fair value of investment in equity and debt securities)	Interest revenue (on investment in debt securities)
Cumulative unrealized holding gains and losses on equity and debt securities classified as available-for-sale securities (equity account)	Realized gains and losses (on equity and debt security transactions)
Investments in equity securities accounting for by the equity method (investor exercises significant influence over investee)	Unrealized holding gains and losses on equity and debt securities classified as trading (changes in fair value during the current period)
Investments in equity securities accounting for at cost (fair value not determinable)	Equity in investee's earning (for investments account for by the equity method)
Investments in debt securities classified as held-to-maturity (carried at amortized cost)	

The variety of accounts listed above indicates that the auditor must be familiar with the many dimensions of valuation, classification, and disclosures pertaining to investments in equity and debt securities.

Figure 18-1 ■ Selected Specific Audit Objectives for Short-term and Long-term Investments

Specific Audit Objectives
Transaction Objectives
Occurrence. Recorded purchases **(EO1)** and sales **(EO2)** of investments, and investment revenues, realized gains and losses, and unrealized gains and losses **(EO3)** resulted from transactions that occurred during the period.
Completeness. The effects of all investment purchases **(C1),** sales **(C2),** and income transactions and events **(C3)** that occurred during the period were recorded.
Accuracy. Recorded purchases **(VA1)** and sales **(VA2)** of investments, and investment revenues, realized gains and losses, and unrealized gains and losses **(VA3)** accurately valued using GAAP and correctly journalized, summarized, and posted.
Cutoff. Recorded purchases **(EO1 and C1)** and sales **(EO2 and C2)** of investments, and investment revenues, realized gains and losses, and unrealized gains and losses **(EO3 and C3)** have been recorded in the correct accounting period.
Classification. All purchases **(PD1)** and sales **(PD2)** of investments, and investment revenues, realized gains and losses, and unrealized gains and losses **(PD3)** have been recorded in the proper accounts.
Balance Objectives
Existence. Recorded short-term and long-term investments represent investments that exist at the balance sheet date **(EO4).**
Completeness. All short-term and long-term investments are included in the balance sheet investment accounts **(C4).**
Rights and Obligations. The entity owns or has rights to all recorded short-term and long-term investments **(RO1).**
Valuation and Allocation. Short-term and long-term investments are reported on the balance sheet at fair value, cost, amortized cost, or the amount determined by the equity method, as appropriate for particular investments **(VA4).**
Disclosure Objectives
Occurrence and Rights and Obligations. Disclosed short-term and long-term investment events and transactions have occurred and pertain to the entity **(PD4).**
Completeness. All short-term and long-term investment disclosures that should have been included in the financial statements have been included **(PD5).**
Classification and Understandability. All short-term and long-term investment information is appropriately presented and described, and information in disclosures is clearly expressed **(PD6).**
Accuracy and Valuation. Short-term and long-term investment information is disclosed accurately and at appropriate amounts **(PD7).**

AUDIT OBJECTIVES

For each of the five categories of financial statement assertions, Figure 18-1 lists a number of specific audit objectives pertaining to accounts affected by short-term and long-term investment transactions. Considerations and procedures relevant to meeting these objectives are explained in the following sections.

UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT

The significance of investments in short-term and long-term securities depends in large part on an entity's ability to generate free cash flow (cash flow from operations less capital expenditures). Companies with significant free cash flow must

Audit Decision 2

■ What audit planning decisions should be made when developing an audit program for the audit of short-term and long-term investments?

regularly address how to invest excess cash. Some companies may have times in their annual business cycle when they are generating sufficient cash flow that they seek short-term investments to generate some earnings on their excess cash. For example, if a school district receives a property tax remittance in one lump sum, it will want to find a secure investment opportunity to generate income as it progressively draws down on the investment to cover operating costs. Knowledge of an entity's sources of cash flow should assist the auditor in developing expectations regarding short-term and long-term investments.

ANALYTICAL PROCEDURES

Within an industry, the audit of investments will vary significantly from one company to another. For example, various companies in the retail grocery business face the same challenges in inventory management, which allows for effective industry comparisons. However, each retail grocer may have varying amounts of excess cash to invest in the securities of other companies, so it is more difficult to make meaningful comparisons with industry data. As a result, it is more difficult to obtain independent, reliable data to develop an expectation. Auditors may compare current-year and prior-year balances, or they may compare actual results for the amount of investments and investment income with budgets or other documentation of management's plans.

Unexpected differences might indicate misstatements pertaining to the existence or occurrence, completeness, valuation or allocation, and presentation and disclosure assertions. For example, a higher-than-expected rate of return on trading securities might be found to have been caused by erroneously recording the unrealized gain from an increase in the fair value of available-for-sale securities in the income account for trading securities rather than in the equity account for unrealized gains on available-for-sale securities. Similarly, a lower-than-expected rate of return on an equity method investment might result from an error in recording (1) the investor's share of the investee's earnings or (2) amortization of the excess of the investor's cost over the underlying book value of the investment.

INHERENT RISK

Inherent risk for investments is affected by many factors. The volume of investing transactions is generally quite low. However, securities are susceptible to theft, and the accounting for investments can become complex. Examples of the latter include certain equity method investments for which the acquisition costs exceed book values, and the accounting required when certain investments are reclassified from one category to another. In addition, certain inherent risks are more challenging to address with controls, and afford management an opportunity for manipulating the reporting for investments. Specifically, the proper classification of an investment may be contentious, which in turn affects the valuation method, income effects, and disclosure requirements applicable to the investment. For example, the accounting treatment of debt securities classified as *held-to-maturity* versus *available-for-sale* is quite different, as is the treatment of equity securities classified as *available-for-sale* versus *trading*. By misrepresenting the appropriate classification of an investment, management can defer or accelerate the recognition of unrealized gains and losses in income. Moreover, fair values, when required, may be difficult to determine or they may be volatile. Thus, these factors, when applicable, may contribute to high levels of inherent risk for the valuation or allocation and presentation and disclosure assertions.

CONSIDERATION OF INTERNAL CONTROLS

The understanding of several *control environment* factors is relevant to the audit of the investing cycle. For example, the authority and responsibility for investing transactions should be assigned to a company officer such as the treasurer. This individual should be a person who (1) is of unquestioned integrity, (2) possesses the knowledge and skills required of a person charged with executing such transactions, (3) realizes the importance of observing all prescribed control procedures, and (4) can assist other participating members of management in making initial and ongoing assessments of risks associated with individual investments.

The *information and communication system* must capture and retain all the necessary cost, fair value, and other data required for each method of accounting for the various categories of investments in equity and debt securities, both at acquisition and at subsequent reporting dates. Thus, accounting personnel must be familiar with these requirements and be capable of implementing them. Separate subsidiary investment ledgers may be maintained for the various categories of investments.

Each category of control activities applies to investments. Several common documents and records used in investing activities are explained in the next section, followed by descriptions of important investing functions and selected control activities pertaining to each. In a strong system of internal controls, an investment committee sets investing policy and reviews investing transactions. In addition, internal auditors and the board of directors should closely monitor the effectiveness of controls over investing activities.

Common Documents and Records

The documents and records applicable to this cycle are

- **Stock certificate.** An engraved, prenumbered form showing the number of shares of stock owned by a shareholder in a corporation. This document provides evidence for the existence or occurrence assertion.
- **Bond certificate.** An engraved, prenumbered form showing the number of bonds owned by a bondholder.
- **Bond indenture.** A contract stating the terms of bonds issued by a corporation.
- **Broker's advice.** A document issued by a broker specifying the exchange price of investing transactions; it is the primary source document for recording investing transactions. The advice provides evidence for the valuation or allocation assertion.
- **Broker's statement.** A monthly statement issued by a broker specifying securities held in safekeeping by the broker, their cost, and their fair-market value at the end of the month. In addition, the monthly statement usually summarizes any transactions that took place during the month.
- **Books of original entry.** The general journal is often used to record such items as the accrual of bond interest revenue, market adjustments under the fair-value method, and income earned under the equity method of accounting. The cash receipts journal is used to record the proceeds from sales transactions and the

receipt of interest and dividends. The voucher and check registers are used in purchasing and paying for the cost of securities.

- **Investment subsidiary ledger.** Separate subsidiary ledgers may be used for each different class of investments when the company has a portfolio consisting of many different investments.

Functions and Related Controls

Activities in the investing cycle include the following **investing functions** and related controls:

- *Authorize investment transactions:*
  - *Purchasing securities.* Purchases are made in accordance with management's authorizations.
  - *Selling securities.* Sales are made in accordance with management's authorizations.
- *Receive or deliver securities:*
  - *Receiving/safeguarding/delivering securities.* Securities are usually held in safekeeping by a broker, who is responsible for the safekeeping of securities along with the receipt and delivery of securities for the entity. In rare instances securities are stored in safes or vaults, and access should be restricted to authorized personnel; securities should be periodically inspected, and counted and compared with recorded balances.
  - *Receiving periodic income.* Dividend and interest checks are promptly deposited intact. When securities are held in safekeeping, dividend and interest income is deposited directly to the entity's account by the broker.
- *Record transactions:*
  - *Recording purchases, sales, and income.* Transactions are recorded based on appropriate supporting documentation; the duties of recording transactions and maintaining custody of the securities are segregated. Comparing recorded transactions to underlying information on a broker's advice normally controls the occurrence, accuracy, and cutoff objectives. An investment committee (that has individuals with knowledge of investing activities and an understanding of accounting for investing activities) is usually responsible for evaluating the classification of securities.
  - *Recording market adjustments and reclassifications.* Changes in fair values and in circumstances pertaining to the proper classification of investments are periodically analyzed and recorded. The investment committee should review the classification, valuation, and unrealized gains and losses on trading securities on a monthly or quarterly basis.
  - *Reviewing purchases, sales, and income transactions.* This review by an investment committee provides independent checks on the accounting function.
- *Settle transactions:*
  - *Receiving cash.* Control procedures should provide reasonable assurance that documentation establishing accountability is created for cash receipts from the sale of investments and for the transfer of funds from a brokerage account to the primary checking account. See controls over cash receipts discussed in Chapter 14.

- *Disbursing cash.* Cash disbursements to settle purchases of investments should include comparisons of disbursements with underlying brokerage advices and controls over the transfer of funds to a brokerage account from the primary checking account. See controls over cash disbursements discussed in Chapter 15.
- *Assessing investment performance and reporting.* Performance reviews are made by management and an independent investment committee to detect poor investment performance and/or erroneous reporting, including comparisons of investment balances and rates of return for various classes of investments with budgeted amounts, and reviews of the propriety of the classification of individual investments.

Careful consideration of the foregoing descriptions of investing functions should suggest a variety of potential misstatements that could occur in investment balances.

LEARNING CHECK

18-1 Describe the nature of investments in the securities of other entities.
18-2 State the audit objectives for each of the management assertions that pertain to the audit of investments.
18-3 a. Shad Sloan contends that investments are seldom material to the financial statements. Is Shad correct? Explain.
b. Keri Kline states that it is difficult to compare investing activities with industry norms in auditing investments. Is Keri right? Explain.
18-4 Describe the applicability of internal control structure components to the investing cycle.
18-5 a. Identify and describe the functions that pertain to investing cycle transactions.
b. Using your knowledge of internal control design, explain how each assertion would be controlled for investing activities.

KEY TERMS

Bond certificate, p. 852
Bond indenture, p. 852
Books of original entry, p. 852
Broker's advice, p. 852
Broker's statement, p. 852
Investing functions, p. 853
Investing transactions, p. 849
Investment subsidiary ledger, p. 853
Stock certificate, p. 852

Audit Decision 3

- What factors are involved in determining an acceptable level of tests of details risk for short-term and long-term investments?

PRELIMINARY AUDIT STRATEGIES

Figure 18-2 summarizes some key issues related to preliminary audit strategies for the audit of short-term and long-term investments. This is an audit area where the population of investing transactions is often small. As a result of small population sizes, many auditors will follow a primarily substantive approach. Nevertheless, auditors of public companies need to perform sufficient tests of controls to support an opinion on internal controls. Controls over cash receipts and cash dis-

Figure 18-2 ■ Example Preliminary Audit Strategies for Investments

Assertion	Inherent Risk	Control Risk	Analytical Procedures Risk	Test of Details Risk
Existence and Occurrence	Maximum: Short-term and long-term investments represent liquid resources that may be susceptible to misappropriation.	Low: Strong controls over cash disbursements and cash receipts investment transactions. Additional controls include monthly comparison of subsidiary records with broker's statements.	High: Comparing financial data for year-to-year comparison of balances and investment income.	Low: The auditor will usually directly confirm investments and investment activity with brokers, or compare with broker's statements.
Completeness	Moderate to Maximum: Completeness problems may result if funds intended for investment are misappropriated.	Low: Strong controls over cash disbursements and cash receipts investment transactions. Additional controls include monthly comparison of subsidiary records with broker's statements.	High: Comparing financial data for year-to-year comparison of balances and investment income.	Moderate: The auditor will usually directly confirm investments and investment activity with brokers, or compare with broker's statements.
Rights and Obligations	Moderate to High: Securities may be pledged as collateral for loans.	Moderate: Primary control is the involvement of an effective investment committee that reviews investment transactions.	Maximum: Analytical procedures are not directed at the rights and obligations assertion.	Moderate: The auditor will usually directly confirm investments and investment activity with brokers, or compare with broker's statements.
Valuation or Allocation	High to Maximum: The major valuation issues are associated with the fair value of trading investments and accounting for unrealized gains and losses.	Moderate or High: Controls over routine transactions are related to controls over cash disbursements and cash receipts. Primary control over estimates includes effective involvement of independent investment or disclosures committees.	High: Comparing financial data for year-to-year comparison of balances and investment income.	Low: The auditor will usually directly confirm investments and investment activity with brokers, or compare with broker's statements. Often fair values can readily be tested to independent sources.
Presentation and Disclosure	Moderate to High: Classification issues exist with respect to credit balances. Also, there are important disclosures related to compensating balance agreements and other restrictions on cash.	Moderate or Maximum: Primary control is the involvement of an effective investment or disclosure committee.	Maximum: Analytical procedures are not directed at disclosures.	Low: The auditor will often perform tests of details to evaluate the quality and accuracy of financial statement disclosures.

bursements are usually tested as part of the revenue and expenditure cycles. The following discussion focuses on a preliminary audit strategy developed for a private company.

SUBSTANTIVE TESTS OF SHORT-TERM AND LONG-TERM INVESTMENTS

Audit Decision 4

■ **How does the auditor determine the elements of an audit program for substantive tests to achieve specific audit objectives for short-term and long-term investments?**

A list of possible substantive tests of investments and the specific audit objectives to which they relate is presented in Figure 18-3. Note that the tests of details of balances category contains the largest number of possible tests, and that a variety of tests can contribute to achieving the low acceptable levels of detection risk that may be needed for the valuation or allocation and presentation and disclosure assertions. Each of the tests is explained in a following section.

Initial Procedures

The series of procedures in this category as shown in Figure 18-3 follows the pattern established for major accounts in the other cycle chapters. That is, first, the auditor obtains an understanding of the entity and its environment. It is important for the auditor to understand the economic drivers that allow an entity to engage in investing activities, such as an entity's policy for investing excess cash, its financing activities, and its ability to generate free cash flow. Second, agreement of beginning investment balances with audited amounts in the prior year's working papers is verified. Next, the activity in investment-related accounts is reviewed to determine the presence of any entries that are unusual in nature or amount that should be investigated. Then, client-prepared schedules of all investments, or additions and disposals in the current period, are checked for mathematical accuracy and agreement with the underlying accounting records. The latter procedure includes determining that schedules and subsidiary investment ledgers agree with related general ledger control account balances. The schedules can then serve as the basis for additional substantive tests.

Analytical Procedures

Analytical procedures for investment balances involve the interrelationship of specific accounts within the current period and comparisons with prior-year data, budgeted amounts, or other expectations. For example, the percentage of short- and long-term investment balances to current and total assets, respectively, and rates of return on various classes of investments can be compared with expectations. When performing analytical procedures in investment income, it is important to understand the entity's investment policy regarding the proportion of investments in government securities, corporate bonds, and equity securities. The auditor should evaluate the reasonableness of investment income for each class of investments separately, based on recent market performance. The effectiveness of analytical procedures discussed earlier in the chapter may reduce the amount of evidence needed from other substantive tests.

Tests of Details of Transactions

Tests of details of transactions may be particularly effective as an audit approach when the entity has a low volume of transactions. These substantive tests consist

Figure 18-3 ■ Possible Substantive Tests of Short-Term and Long-Term Investments

Category	Substantive Test	Specific Audit Objectives
Initial Procedures	1. Obtain an understanding of the entity and its environment and determine:	All
	a. The significance of investment balances and transactions to the entity. b. The entity's policies for investing surplus cash balances. c. Key economic drivers that influence the entity's acquisition of investments, including the entity's ability to utilize cash flowing from financing activities to generate free cash flow.	
	d. Industry standards for the extent to which investments are important to the entity and their impact on earnings.	VA4
	2. Perform initial procedures on investment balances and records that will be subjected to further testing. a. Trace beginning balance for investment assets and equity accounts to prior year's working papers.	All
	b. Review activity in all investment-related balance sheet and income statement accounts and investigate entries that appear unusual in amount or source.	VA4
	c. Obtain client-prepared schedules of investments, and determine that they accurately represent the underlying accounting records from which they were prepared by: i. Footing and crossfooting the schedules and reconciling the totals with related subsidiary and general ledger balances. ii. Testing agreement of items on schedules with entries in related subsidiary and general ledger accounts.	VA4
Analytical Procedures	3. Perform analytical procedures: a. Calculate ratios: i. Short-term investments to total assets. ii. Long-term investments to total assets. iii. Rates of return by investment classification. b. Analyze ratio results relative to expectations based on prior years, budgeted, or other data.	All
Tests of Details of Transactions	4. On a test basis, vouch entries in investment and related income and equity accounts.	EO1-3, C1-3, VA1-3, PD1-3
Tests of Details of Balances	5. Inspect and count securities on hand.	EO4, C4, RO1
	6. Confirm securities held by others.	EO4, C4, RO1
	7. Recalculate investment revenue earned.	EO4, C4, VA4
	8. Determine the appropriate classification of held-to-maturity securities, trading securities, and available-for-sale securities by reference to: a. Documentation of management's stated intent. b. Whether management's actions are consistent with management's stated intent. c. Management's ability to hold debt securities to maturity. d. Written representation from management confirming the proper classification of securities.	PD4
	9. Obtain evidence corroborating the fair value of investments at balance sheet date, including, but not limited to: a. Quoted market prices obtained from financial publications. b. Fair-value estimates obtained from broker dealers and other third-party sources. c. Evaluation of the appropriateness of valuation models.	VA4
Presentation and Disclosure	10. Compare statement presentation with GAAP.	
	a. Determine the investment balances are properly identified and classified in the financial statements.	PD4, PD7
	b. Determine the appropriateness of disclosures concerning the valuation bases for investments, realized and unrealized gain or loss components, related party investments, and pledged investments.	PD4, PD7
	c. Evaluate the completeness of presentation and disclosures for investments in drafts of financial statements to determine conformity to GAAP by reference to disclosure checklist.	PD6
	d. Read disclosures and independently evaluate their classification and understandability.	PD6

of vouching the individual debits and credits in the various investment accounts. For example, debits to asset accounts for acquisition transactions can be vouched to brokers' advices and canceled checks. Other debits to the investment accounts or related market adjustment accounts can be vouched to documentation verifying increases in fair values to be recognized in the accounts. Credits posted to asset accounts can be vouched to bank or broker's advices evidencing the sale of investments, or to documentation of decreases in fair values to be recognized in the accounts. Similarly, entries to income statement and equity accounts for realized and unrealized gains and losses can be vouched to documentation of sales transactions or changes in fair values based on independently published market values. Entries for major purchases and sales of investments can often be vouched to authorizations in the minutes of the board of directors.

For investments accounted for by the equity method, post-acquisition debits can be vouched to documentation showing the investor's share of the investee's earnings. Credits can be vouched to documentation of dividends received from investees or to worksheets showing the calculation of the periodic amortization of the excess of cost over underlying book value. Audited financial statements of the investee generally constitute sufficient evidence regarding the underlying net assets and the results of operations of the investee. If the financial statements of the investee are not audited, the auditor should apply, or should request that the client arrange with the investee to have the investee's auditor apply, appropriate auditing procedures to such financial statements, considering the materiality of the investment in relation to the financial statements of the client.

Knowledge of the proper accounting for investing activities affecting other investment balances will inform the auditor as to the sources to which the debits and credits can be vouched. Depending on the particular debits or credits being vouched, careful examination of the supporting documentation can provide evidence bearing on any of the five categories of assertions. For example, brokers' advices provide evidence about the existence or occurrence of transactions, the transfer of ownership of securities, and the valuation of the securities at the transaction date. Documentation may also be helpful in determining that the debits and credits have been made to the proper accounts (proper classification).

Tests of Details of Balances

Three substantive tests in this category are explained in the following subsections.

Inspect and Count Securities on Hand

This test ordinarily is performed simultaneously with the auditor's count of cash and other negotiable instruments. In performing the test, (1) the custodian of the securities should be present throughout the count, (2) a receipt should be obtained from the custodian when the securities are returned, and (3) all securities should be controlled by the auditor until the count is completed.

In inspecting securities, the auditor should observe such matters as the certificate number on the document, name of owner (which should be the client, either directly or through endorsement), description of the security, number of shares (or bonds), and name of issuer. These data should be recorded as part of the auditor's analysis of the investment account. Figure 18-4 illustrates an audit working paper for one class of equity securities. For securities purchased in prior years, the data should be compared with those shown on last year's working papers. A lack of

Figure 18-4 ■ Available-for-Sale Securities Working Paper

Williams Company
Available for Sale Securities
December 31, 20X1

W/P Ref. H-2
Prepared By: A.E.R. Date: 2/3/X2
Reviewed By: R. E. G. Date: 2/10/X2

Description	Ctf. No.	Date Acquired	No. of Shares	Cost Per Share	Balances 1/1/x1	Purchases	Sales	Balances 12/31/x1	Mkt Price Per Share	Mkt Value 12/31/x1	Dividend Income
General Mfg. Co.	C2779	4/21/x0	900	$ 22.00	$ 19,800 a			$ 19,800 d	$ 24.50 e	$ 22,050 d	$ 675 f
Metropolitan Edison	M82931	9/21/x0	500	$ 33.20	$ 16,600 a		$ 16,600 c	$— d		d	$ 127
Pacific Papers, Inc.	54942	2/14/x1	200	$ 18.50	$—	$ 3,700 c		$ 3,700 d	$ 17.00 e	$ 3,400 d	$— f
Warrenton Corp.	7336	7/19/x0	400	$ 27.25	$ 10,900 a			$ 10,900 d	$ 29.25 e	$ 11,700 d	$ 120 f
					$ 47,300 a	$ 3,700	$ 16,600	$ 34,400 b		$ 37,150	$ 922 b
					F	F	F	FF to H-1		F	F to H-1 to R-1

Fair Value over (under) cost at 12/31/x1	$ 2,750
Balance in Market Adjustement – Available for Sale Securities Account: 12/31/x1	$ 1,250
Current Adjustment Required : Increase (Decrease)	$ 1,500
	AE

F) Footed
FF) Footed and Crossfooted
a) Agreed to prior year's working papers
b) Traced to general ledger
c) Vouched to brokers' advices and board of directors' authorization
d) Extension checked
e) Per market quotation in *Wall Street Journal* 1/2/x2
f) Dividend rates check to Standard and Poor's; dividends received to cash receipts journal

AE: Adjusting entry posted to W/P AE – 2

Market Adjustment Available-for-Sales Securities	$ 1,500	
Unrealized Gain (Loss) in Available for Sale Securities		$ 1,500

agreement between the certificate numbers may be indicative of unauthorized transactions for those securities. When the count is not made on the balance sheet date, the auditor should prepare a reconciliation from the date of count to the statement date by reviewing any intervening security transactions.

Confirm Securities Held by Others

Material securities held by outsiders for safekeeping should be confirmed. Confirmations should be requested as of the date securities held by the client are counted. The confirmation process for securities is identical with the steps required in confirming receivables. Thus, the auditor must control the mailings and receive the responses directly from the custodian. The data confirmed are the same as the data that should be noted when the auditor is able to inspect the securities. Securities may also be held by creditors as collateral against loans or be placed in escrow by court order. In such cases, the confirmation should be sent to the indicated custodian.

Recalculate Investment Revenue Earned

Income from investments is verified by documentary evidence and recalculation.

- Dividends on all stocks listed on stock exchanges and many others are included in published investment services. The auditor can independently verify the dividend revenue by reference to the declaration date, amount, and payment date shown in the record book. The verification of dividend income is usually incorporated into the schedule of investments, as illustrated in Figure 18-4.
- Interest earned and interest collected on investments in bonds can be verified by examining the interest rates and payment dates indicated on the bond certificate. In addition, the auditor reviews the client's amortization schedule for bond premium and discount and recalculates the amount amortized, if any.
- Verification of the investor's share of investee earnings for equity method investments was discussed as part of vouching entries in the earlier section on tests of details of transactions. Recalculation of investment revenue balances pertains primarily to the valuation or allocation assertion.

Tests of Details of Accounting Estimates

When auditing investments, the auditor must apply significant audit judgment with respect to evaluating (1) the proper classification of investments and (2) the fair value of investments. The professional guidance provided by AU 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities,* is discussed below.

Proper Classification of Investments

The appropriateness of the client's application of FASB No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* depends on the entity's classification of securities as:

- Held-to-maturity securities, which are reported at amortized cost.
- Trading securities, which are reported at fair value, with unrealized gains and losses included in earnings.

- Available-for-sale securities, which are reported at fair value with unrealized gains and losses excluded from earnings and reported in a separate equity account.

The auditor should determine whether management's investment activities corroborate or conflict with management's stated intent. For example, sales of investments classified in the held-to-maturity category should cause the auditor to question the appropriateness of management's classification of other investments in that category. The auditor should also consider management's ability to hold a debt security to maturity given the client's financial position, working capital needs, and ability to generate operating cash flow. Finally, the auditor ordinarily should obtain written representation from management confirming the appropriate classification of securities.

Auditing the Fair Value of Investments

If investments are carried at their fair value, the auditor should obtain evidence corroborating the fair value. Common sources for corroborating the fair value of securities include quoted market prices obtained from financial publications or fair-value estimates obtained from broker-dealers and other third-party sources. In the case of investments valued using a valuation model, the auditor does not function as an appraiser and is not expected to substitute his or her judgment for that of the entity's management. Rather, the auditor generally should assess the reasonableness and appropriateness of the model. The auditor may consider it necessary to involve a specialist in assessing the entity's fair-value estimates or related models.

GAAP requires management to determine whether a decline in fair value below the amortized cost basis of certain investments is other than temporary, which often involves the estimation of the outcomes of future events. The auditor should evaluate whether management has considered relevant information in determining whether an other-than-temporary impairment condition exists. Example factors that may indicate an other-than-temporary impairment condition include the following:

- Fair value is significantly below cost.
- The decline in value is attributable to specific adverse conditions affecting a particular investment.
- A debt security has been downgraded by a rating agency.
- The financial condition of the issuer has deteriorated.
- Dividends have been reduced or eliminated, or scheduled interest payments on debt securities have not been made.

The auditor should obtain evidence about such conditions and whether they tend to corroborate or conflict with management's conclusions.

Tests of Details of Presentation and Disclosure

The foregoing substantive tests should provide much of the evidence needed by the auditor to determine whether investment balances are properly identified and classified in the financial statements. However, regarding classification as to current or noncurrent, or trading versus available-for-sale, the auditor must also make inquiries of management concerning its intentions regarding holding periods and so on. In the case of debt securities classified as held-to-maturity, the auditor must also assess the entity's ability to hold the investment until maturity. Most auditors use checklists as an aid in determining that all required disclosures are made concerning valuation bases for investments, the various components of realized and unrealized gains and losses, related party investments, and securities that have been pledged as collateral.

LEARNING CHECK

18-6 What factors are relevant in determining the acceptable level of detection risk for investment balances?

18-7 a. What precautions should be taken in counting and inspecting securities?
b. Identify the financial statement assertions affected by this test.

18-8 What data should be shown in the working papers concerning securities that have been examined by the auditor?

18-9 a. Indicate the form and timing of confirming securities held by outside custodians.
b. State the financial statement assertions affected by this test.

AUDITING CASH BALANCES

Cash balances include undeposited receipts on hand, cash in bank in general checking and savings accounts, and imprest accounts such as petty cash and payroll bank accounts. This represents cash needed to settle obligations and pay payroll, and most entities will move surplus cash to some form of interest-earning investment. Certain balances, such as certificates of deposits, bond sinking fund cash, certain foreign currency balances, and other accounts that have restrictions on their use, should ordinarily be classified as investments.

RELATIONSHIP OF CASH BALANCES TO TRANSACTION CYCLES

Audit Decision 5

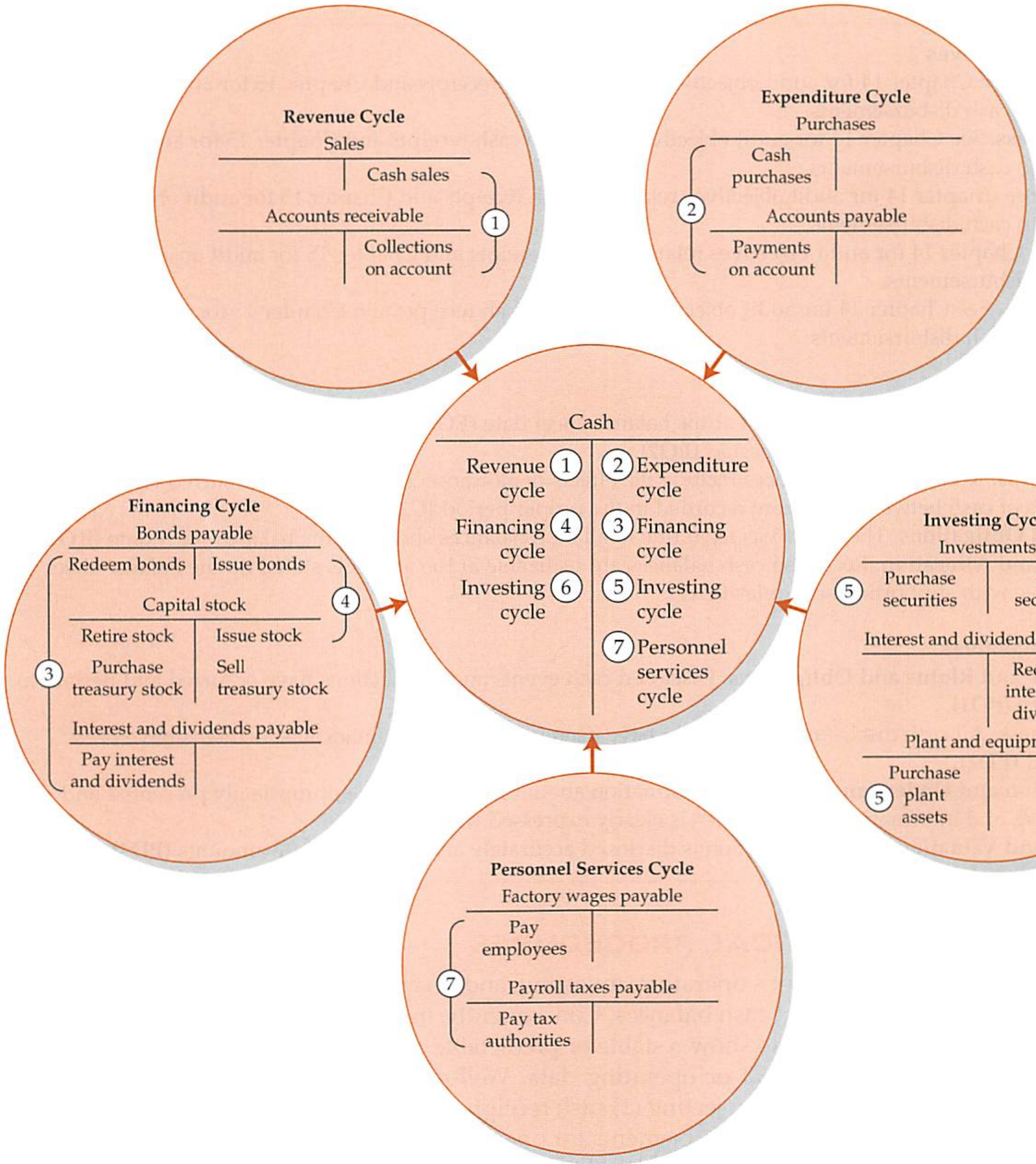
■ What is the relationship of the transaction cycles to cash balances, and how are specific audit objectives developed for cash balances?

Five transaction cycles relate directly to general cash balances, as shown in Figure 18-5. The cycles are revenue, expenditure, financing, investing, and personnel services. The production cycle does not have transactions that relate directly to cash. Note that the financing and investing cycles both increase and decrease cash, whereas the revenue cycle increases, and the expenditure and personnel services cycles decrease, cash. For many entities, the volume of revenue and expenditure cycle transactions is large and can also be large for the personnel services cycle. The volume and size of individual cash transactions in the financing and investing cycles vary greatly from one entity to another and can also vary greatly from year to year for a single entity.

AUDIT OBJECTIVES

Because (1) internal control considerations pertaining to the various transaction classes that affect cash and (2) the related transaction class audit objectives for

Figure 18-5 ■ Relationship of Transaction Cycles to Cash



those transactions are addressed in the previous four chapters, this chapter focuses primarily on substantive tests for cash balances. Chapters 14 and 15 have explained internal controls and tests of transactions for cash receipts and cash disbursements. Accordingly, Figure 18-6 only includes account balance audit objectives for cash balances and disclosures. The substantive tests used to meet these objectives are explained later in the chapter.

Figure 18-6 ■ Selected Specific Audit Objectives for Cash

Specific Audit Objectives
Transaction Objectives
Occurrence. See Chapter 14 for audit objectives related to cash receipts and Chapter 15 for audit objectives related to cash disbursements.
Completeness. See Chapter 14 for audit objectives related to cash receipts and Chapter 15 for audit objectives related to cash disbursements.
Accuracy. See Chapter 14 for audit objectives related to cash receipts and Chapter 15 for audit objectives related to cash disbursements.
Cutoff. See Chapter 14 for audit objectives related to cash receipts and Chapter 15 for audit objectives related to cash disbursements.
Classification. See Chapter 14 for audit objectives related to cash receipts and Chapter 15 for audit objectives related to cash disbursements.
Balance Objectives
Existence. Recorded cash balances exist at the balance sheet date **(EO1).** Year-end transfers of cash between banks are recorded in the proper period **(EO2).**
Completeness. Recorded cash balances include the effects of all transactions that have occurred **(C1).** Year-end transfers of cash between banks are recorded in the proper period **(C2).**
Rights and Obligations. The entity has legal title to all cash balances shown at the balance sheet date **(RO1).**
Valuation and Allocation. Recorded cash balances are realizable at the amounts stated on the balance sheet and agree with supporting schedules **(VA1).**
Disclosure Objectives
Occurrence and Rights and Obligations. Disclosed cash events and transactions have occurred and pertain to the entity **(PD1).**
Completeness. All cash disclosures that should have been included in the financial statements have been included **(PD2).**
Classification and Understandability. All information about cash balances is appropriately presented and described, and information in disclosures is clearly expressed **(PD3).**
Accuracy and Valuation. Cash information is disclosed accurately and at appropriate amounts **(PD4).**

ANALYTICAL PROCEDURES

Audit Decision 6

■ What audit planning decisions should be made when developing an audit program for the audit of cash balances?

Management's operating, investing, and financing decisions and strategies significantly affect cash balances. Consequently, in some audits these balances may not be expected to show a stable or predictable relationship with other current or historical financial or operating data. Well-managed companies regularly develop cash budgets, projecting (1) cash receipts based on anticipated collection of receivables, (2) cash disbursements for operating needs, and (3) investing and financing activities. Effective analytical procedures involve comparing cash balances with forecasts or budgets, or with company policies regarding minimum cash balances and the investment of surplus cash. It is usually more effective to compare cash balances with budgets and company policies because the individual cash needs of various entities are often unique. Auditors normally do not expect to obtain significant assurance from analytical procedures applied to cash balances.

INHERENT RISK

The high volume of transactions alone contributes to a significant level of inherent risk for certain cash balance assertions, particularly existence or occurrence and completeness. In addition, the nature of cash balances makes them susceptible to theft as numerous kinds of fraudulent schemes involving cash have borne out. In contrast to receivables or inventories, however, the risks pertaining to the rights and obligations, valuation or allocation, and presentation and disclosure assertions for cash are minimal due to the absence of complexities involving rights, accounting measurements, estimates, and disclosures.

CONSIDERATION OF INTERNAL CONTROLS

Internal controls related to cash receipts and cash disbursements were discussed in Chapters 14 and 15, respectively. The student should review the discussion in these chapters regarding the internal control elements of the control environment, risk assessment, information and communication, control procedures, and monitoring, including the discussion of key documents and records and common functions and controls. Cash receipts and disbursements often represent routine transactions that can be controlled by a sound system of internal controls, which may allow the auditor to assess control risk at a low level. Because of the susceptibility of cash balances to theft, many auditors carefully evaluate internal controls over cash, and ensure that significant deficiencies in internal control are clearly communicated to management.

LEARNING CHECK

18-10 Identify several types of cash accounts that should be included as cash balances on the balance sheet and several others that should not.

18-11 Which transaction cycles relate directly to cash and how?

18-12 a. State the account balance audit objectives for cash that are associated with each category of financial statement assertions.
b. Indicate the relative degree of inherent risk associated with each assertion category for cash balances.

18-13 Cash balances often constitute a very small percentage of an entity's current or total assets. Why is significant effort allocated to testing controls and performing audit procedures for cash balances?

18-14 What special considerations relate to applying the concepts of materiality and preliminary audit strategies to the audit of cash balances?

PRELIMINARY AUDIT STRATEGIES

Audit Decision 7

■ What factors are involved in determining an acceptable level of tests of details risk for cash balance assertions?

Figure 18-7 summarizes some key issues related to preliminary audit strategies for the audit of cash balances. In this section and the following subsections, the term *cash balances* refers only to cash on hand and in bank, excluding petty cash and other imprest funds. Controls over cash receipts and cash disbursements are usually tested as part of the revenue and expenditure cycles. The audit strategy is highly dependent on tests of effectiveness of internal controls. If internal controls are strong, the auditor may perform less extensive substantive tests and place a greater degree of reliance on internal documentation.

Some small business owners want the auditor to carefully audit cash to provide them assurance about the validity of cash balances. As a result, the auditor will follow a primarily substantive approach emphasizing tests of details even when

Figure 18-7 ■ Example Preliminary Audit Strategies for Cash

Assertion	Inherent Risk	Control Risk	Analytical Procedures Risk	Test of Details Risk
Existence and Occurrence	Maximum: Cash involves a high volume of transactions, and it is highly susceptible to misappropriation.	Low: Strong controls over cash disbursements and cash receipts. Additional controls include independent monthly bank reconciliations.	High: Comparing financial data for year-to-year and comparison of cash balances with cash budgets and forecasts.	Low: The auditor will usually directly confirm bank balances, and tests of bank reconciliation depend on quality of internal controls.
Completeness	Moderate to Maximum: Completeness problems may result if schemes involving the misappropriation of assets are not recorded.	Low: Strong controls over cash disbursements and cash receipts investment transactions. Additional controls include independent monthly bank reconciliation.	High: Comparing financial data for year-to-year and comparison of cash balances with cash budgets and forecasts.	Low: The auditor will usually directly confirm bank balances, and tests of bank reconciliation depend on quality of internal controls.
Rights and Obligations	Low: Significant rights issues do not exist with respect to cash balances.	N/A	Maximum: Analytical procedures are not directed at the rights and obligations assertion.	Moderate: The auditor will usually directly confirm bank balances and any restrictions on cash.
Valuation or Allocation	Moderate: Significant valuation issues do not exist with respect to cash balances.	Low: Strong controls over cash disbursements and cash receipts. Additional controls include independent monthly bank reconciliations.	High: Comparing financial data for year-to-year and comparison of cash balances with cash budgets and forecasts.	Moderate: The auditor will usually directly confirm bank balances. Tests of bank reconciliation depend on quality of internal controls.
Presentation and Disclosure	Moderate to High: There may be concerns about classification of credit balances.	Moderate or Maximum: Primary control is the involvement of an effective disclosure committee.	Maximum: Analytical procedures are not directed at disclosures.	Low: The auditor will often perform tests of details to evaluate the quality and accuracy of financial statement disclosures.