

the audit risk model might indicate that such an approach is not necessary because of the effectiveness of internal controls. Other clients may rely on the CFO, or an internal audit department, to carefully review or audit cash balances and may ask the auditor to design the scope of the audit of cash balances based only on what is necessary to issue an opinion on fair presentation in the financial statements.

SUBSTANTIVE TESTS OF CASH BALANCES

A listing of possible substantive tests to achieve the specific audit objectives for cash balances is presented in Figure 18-8. Not all of the tests are performed in every audit. Each of the tests is explained in a following section, including comments on when certain of the tests might be omitted and how some of them can be tailored based on applicable risk factors.

Figure 18-8 ■ Possible Substantive Tests of Cash Balance Assertions

Category	Substantive Test	Specific Audit Objectives
Initial Procedures	1. Obtain an understanding of the business and industry and determine: <ol style="list-style-type: none"> The significance of cash balances and transactions to the entity. The entity's policies for forecasting cash balances and investing surplus cash balances. 	All
	2. Perform initial procedures on cash balances and records that will be subjected to further testing. <ol style="list-style-type: none"> Trace beginning balance for cash on hand and in bank to prior year's working papers. Review activity in general ledger accounts for cash and investigate entries that appear unusual in amount or source. Obtain client-prepared schedules of cash on hand and in bank, verify mathematical accuracy, and determine agreement with general ledger. 	VA1
		All
		VA1
Analytical Procedures	3. Perform analytical procedures: <ol style="list-style-type: none"> Compare cash balances with budgeted amounts, prior-year balances, or other expected amounts. Calculate cash as a percent of current assets and compare with expectations. 	All
Tests of Details of Transactions	4. Perform cash cutoff tests (note these test may have been performed as part of the audit programs for accounts receivable and accounts payable): <ol style="list-style-type: none"> Observe that all cash received through the close of business on the last day of the fiscal year is included in cash on hand or deposits in transit and that no receipts of the subsequent period are included, or Review documentation such as daily cash summaries, duplicate deposit slips, and bank statements covering several days before and after year-end date to determine proper cutoff. Observe the last check issued and mailed on the last business day of the fiscal year and trace to accounting records to determine the accuracy of the cash disbursements cutoff, or Compare dates on checks issued for several days before and after the year-end date to the dates the checks were recorded to determine proper cutoff. 	EO2, C2
		EO2, C2
		EO2, C2, VA1

(continues)

Figure 18-8 ■ (Continued)

Category	Substantive Test	Specific Audit Objectives
Tests of Details of Balances	5. Trace bank transfers for several days before and after the year-end date to determine that each transfer is properly recorded as a disbursement and a receipt in the same accounting period and is properly reflected in bank reconciliations when applicable.	
	6. Prepare proof of cash for any bank accounts the entity has been unable to reconcile or for which there is a high risk that fraudulent transactions have occurred.	
	7. Count undeposited cash on hand and determine that such amounts are included in cash balances.	EO1, C1, RO1, VA1
	8. Confirm bank deposit and loan balances with banks.	EO1, C1, RO1, VA1
	9. Confirm other arrangements with banks such as lines of credit, compensating balance agreements, and loan guarantees or other parties.	EO1, C1, RO1, VA1
Presentation and Disclosure	10. Obtain, scan, review, and prepare bank reconciliations as appropriate.	EO1, C1, RO1, VA1
	11. Obtain and use bank cutoff statements to verify bank reconciliation items, detect any unrecorded checks that have cleared the bank, and look for evidence of window dressing.	EO1, C1, RO1, VA1
	12. Compare statement presentation with GAAP.	
	a. Determine that cash balances are properly identified and classified in the financial statements.	PD1, PD4
	b. Determine that bank overdrafts are reclassified as current liabilities.	PD1, PD4
	c. Make inquiries of management, review correspondence with banks, and review minutes of board of directors meetings to determine matters requiring disclosure such as lines of credit, loan guarantees, compensating balance agreements, or other restrictions on cash balances.	PD1, PD4
	d. Evaluate the completeness of presentation and disclosures for cash in drafts of financial statements to determine conformity to GAAP by reference to disclosure checklist.	PD2
e. Read disclosures and independently evaluate their classification and understandability.	PD3	

Initial Procedures

Audit Decision 8

■ 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?

Before proceeding with details tests of cash balances, the auditor should ensure that he or she has obtained an understanding of the entity and its environment and the importance of cash balances to the entity. For example, the auditor might understand the volume of transactions going through various cash accounts, the entity's ability to generate positive cash flow from operations, policies for forecasting or budgeting cash, and policies for investing surplus cash. The starting point for verifying cash balances is tracing the current period's beginning balances to the ending audited balances in the prior year's working papers (when applicable). Next, the current period's activity in the general ledger cash accounts should be reviewed for any significant entries that are unusual in nature or amount that require special investigation. In addition, any schedules prepared by the client showing summaries of undeposited cash receipts at different locations and/or summaries of bank balances are obtained. The mathematical accuracy of any such schedules should be determined and their agreement with related cash balances in the general ledger checked. This test provides evidence about the valuation or allocation assertion.

Analytical Procedures

As previously discussed, the effectiveness of analytical procedures varies significantly from client to client. The effectiveness of analytical procedures discussed earlier in the chapter may reduce the amount of evidence needed from other substantive tests relative to that required when the data do not conform to reasonable expectations developed from cash budgets or forecasts, or company policies regarding the investment of surplus cash.

Tests of Details of Transactions

As discussed previously in Chapters 14 and 15, some substantive tests of details involving the tracing and vouching of cash receipts and cash disbursements transactions are ordinarily performed concurrently with tests of controls as dual-purpose tests. The evidence from such tests should be combined with the evidence from the procedures discussed here in reaching a conclusion as to the fair presentation of cash balances. In the next two subsections, consideration is given to two tests of transactions that are generally performed at or near the balance sheet date.

Perform Cash Cutoff Tests

A proper cutoff of cash receipts and cash disbursements at the end of the year is essential to the proper statement of cash at the balance sheet date. Two **cash cutoff tests** are performed: (1) a cash receipts cutoff test, which is explained in Chapter 14, and (2) a cash disbursements cutoff test, as explained in Chapter 15. The use of a bank cutoff statement, described below, is also helpful in determining whether a proper cash cutoff has been made. Cash cutoff tests are directed primarily at the financial statement assertions of existence or occurrence and completeness.

Trace Bank Transfers

Many entities maintain accounts with more than one bank. A company with multiple bank accounts may make authorized transfers of money between bank accounts. For example, money may be transferred from a general bank account to a payroll bank account for payroll checks that are to be distributed on payday. When a bank transfer occurs, several days (called the float period) generally will elapse before the check clears the bank on which it is drawn. Thus, cash on deposit per bank records will be overstated during this 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. Bank transfers may also result in a misstatement of the bank balance per books if the disbursement and receipt are not recorded in the same accounting period.

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 a form of fraud known as **kiting**. Kiting may be used to conceal a cash shortage or overstate cash in bank at the statement date.

An auditor requires evidence on the validity of bank transfers or, conversely, of misstatements therein. This is obtained by preparing a **bank transfer schedule**. Data for the schedule are obtained from an analysis of the cash entries per books and applicable bank and cutoff bank statements. The schedule lists all transfer checks issued at or near the end of the client's fiscal year, and shows the dates that the checks were recorded by the client and the bank, as illustrated in Figure 18-9.

Audit Decision 9

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

Figure 18-9 ■ Bank Transfer Schedule

Check No.	Bank Accounts		Amount	Disbursement Date		Receipt Date	
	From	To		Per Books	Per Bank	Per Books	Per Bank
4100	General	Payroll	\$ 50,000	12/31	1/3	12/31	1/2
4275	General	Branch #1	\$10,000	12/31	1/4	1/2	1/2
4280	General	Branch #2	\$20,000	1/2	1/2	12/31	12/31
B403	Branch #4	General	\$ 5,000	1/2	1/3	1/3	12/31

If we assume all checks are issued on December 31, check 4100 in Figure 18-9 has been handled properly because both book entries were made in December and both bank entries occurred in January. This check would be listed as an outstanding check in reconciling the general bank account at December 31 and as a deposit in transit in reconciling the payroll bank account. Check 4275 illustrates a transfer check in transit at the closing date. Cash per books is understated \$10,000 because the check has been deducted from the balance per books by the issuer in December, but has not been added to the Branch #1 account per books by the depositor until January. Thus, an adjusting entry is required at December 31 to increase the branch balance per books.

Checks 4280 and B403 illustrate the likelihood of kiting because these December checks were not recorded as disbursements per books until January, even though they were deposited in the receiving banks in December. Check 4280 results in a \$20,000 overstatement of cash in bank because the receipt per books occurred in December, but the corresponding book deduction was not made until January. Check B403 may illustrate an attempt to conceal a cash shortage because the bank deposit occurred in December presumably to permit reconciliation of bank and book balances, and all other entries were made in January.

Kiting is possible when weaknesses in internal controls allow one individual to issue and record checks (i.e., improper segregation of duties), or there is collusion between the individuals who are responsible for the two functions. In addition to tracing bank transfers, kiting may be detected by (1) obtaining and using a bank cutoff statement (as discussed in a later section) because the kited check clearing in January will not appear on the list of outstanding checks for December and (2) performing a cash cutoff test because the last check issued in December will not be recorded in the check register.

Count Cash on Hand

Undeposited cash receipts and change funds are ordinarily considered cash on hand. To properly perform **cash counts**, the auditor should:

- Control all cash and negotiable instruments held by the client until all funds have been counted.
- Insist that the custodian of the cash be present throughout the count.
- Obtain a signed receipt from the custodian on return of the funds to the client.
- Ascertain that all undeposited checks are payable to the order of the client, either directly or through endorsement.

vault teller lacked cents

A long-term bank employee worked as a vault teller in a large commercial bank vault that contained large quantities of bagged coins. In previous audits, he had observed that the auditors selected bags positioned in the front rows of the bins for test counting because moving the front bags and counting the bags in the back of the bins were physically difficult. The vault teller devised a scheme to put pennies in the quarter bags in the back rows. A newly hired staff auditor misunderstood the audit instructions and attempted to physically count all bagged coins. On opening all the quarter bags, much to the dismay of the vault teller, the auditor discovered the irregularity which amounted to a \$3,800 vault shortage. The vault teller confessed to the scheme and was prosecuted. New procedures were implemented to include periodic test counts and to open bags to verify correct denominations.

Source: Hilliard T. Steele, ed., "Fraud Findings," *The Internal Auditor* (April 1990), p. 67.

The control of all funds is designed to prevent transfers by the client of counted funds to uncounted funds. The sealing of funds and the use of additional auditors are often required when cash is held in many locations. The safeguards pertaining to the custodian serve to minimize the possibility, in the event of a shortage, of the client claiming that all cash was intact when released to the auditor for counting.

Tests to Detect Lapping**Audit Decision 10**

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

Lapping is a form of fraud that results in the deliberate misappropriation of cash receipts. It may involve either a temporary or a permanent abstraction of cash receipts for the personal use of the individual perpetrating the unauthorized act. 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 accounts receivable ledger. The auditor should assess the likelihood of lapping in obtaining an understanding about the segregation of duties in the receiving and recording of collections from customers.

To illustrate lapping, assume on a given day that cash register tapes totaled \$600 and mail receipts opened by the lapper consisted of one payment on account by check for \$200 from customer A. The lapper would proceed to take \$200 in cash and destroy all evidence pertaining to the mail receipt except for the customer's check. The cash receipts journal entry would agree with the register tape (\$600), and the deposit slip would show cash \$400 and A's check for \$200. These facts can be tabulated as follows:

ACTUAL RECEIPTS		DOCUMENTATION		JOURNAL ENTRY		BANK DEPOSIT SLIP	
Cash	\$600	Cash Tape	\$600	Cash Sales	\$600	Cash	\$400
A check	<u>\$200</u>		<u>\$ —</u>		<u>\$ —</u>	A check	<u>\$200</u>
	<u>\$800</u>		<u>\$600</u>		<u>\$600</u>		<u>\$600</u>

In an effort to conceal the shortage, the defrauder usually attempts to (1) keep bank and book amounts in daily agreement so that a bank reconciliation will not

detect the irregularity and (2) correct the customer’s account within three to four days of actual collection so that any discovered discrepancy in the customer’s account can be explained as a delay in receiving the money or posting. To accomplish the latter, the abstraction is shifted to another customer’s account several days later as follows:

ACTUAL RECEIPTS		DOCUMENTATION		JOURNAL ENTRY		BANK DEPOSIT SLIP	
Cash	\$500	Cash Tape	\$500	Cash Sales	\$500	Cash	\$400
B check	\$300	A check	\$200	A check	\$200	B check	\$300
	<u>\$800</u>		<u>\$700</u>		<u>\$700</u>		<u>\$700</u>

The total shortage is now \$300—\$200 from the first example plus \$100 from the second example.

Tests to detect lapping are performed only when control risk for cash receipts transactions is moderate or high. There are three procedures that should detect lapping.

- *Confirm Accounts Receivable.* This test will be more effective if it is performed on a surprise basis at an interim date. Confirming at this time will prevent the individual engaged in lapping from bringing the “lapped” accounts up to date. Confirmation at the balance sheet date may be ineffective because the “lapper” may anticipate this procedure and adjust the “lapped” accounts to their correct balances at this date.
- *Make a Surprise Cash Count.* The cash count will include coin, currency, and customer checks on hand. The auditor should oversee the deposit of these funds. Subsequently, the details of the deposit shown on the duplicate deposit slip should be compared with cash receipts journal entries and postings to the customers’ accounts.
- *Compare Details of Cash Receipts Journal Entries with the Details of Corresponding Daily Deposit Slips.* This procedure should uncover discrepancies in the details such as those shown in the two examples above. When there is appropriate segregation of duties in the handling of mail receipts, some auditors prefer to use prelists in this procedure. In such a case, the dates of the actual collections are compared with the dates of the postings of the collections to the accounts receivable ledger.

Tests of Details of Balances

Confirm Bank Deposit and Loan Balances

It is customary for the auditor to obtain a **bank confirmation** for cash on deposit and loan balances as of the balance sheet date. Figure 18-10 illustrates a *Standard Form to Confirm Account Balance Information with Financial Institutions*. This form was jointly developed and approved by the American Bankers Association, the AICPA, and the Bank Administration Institute. Notice that the form requests information about the following three items: (1) deposit balances, (2) loan balances, and (3) other deposit or loan accounts that may have come to the attention of the authorized bank official.

Audit Decision 11

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

Figure 18-10 ■ Standard Confirmation Form for Bank Balances

STANDARD FORM TO CONFIRM ACCOUNT BALANCE INFORMATION WITH FINANCIAL INSTITUTIONS

ORIGINAL
To be mailed to accountant

Financial Institution's Name and Address []

[]

CUSTOMER NAME

We have provided to our accountants the following information as of the close of business on _____, 20____, 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 nor 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.

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

ACCOUNT NAME	ACCOUNTS NO.	INTEREST RATE	BALANCE*

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

ACCOUNTS NO./ DESCRIPTION	BALANCE*	DATE DUE	INTEREST RATE	DATE THROUGH WHICH INTEREST IS PAID	DESCRIPTION OF COLLATERAL

(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.

(Financial Institution Authorized Signature)

(Title)

(Date)

EXCEPTIONS AND/OR COMMENTS

Please return this form directly to our accountants: []

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

Approved 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 1003, NY, NY 10108-1003

The confirmation request is prepared in duplicate and signed by an authorized check signer of the client. Both copies are sent to the bank, and the original is returned to the auditor. To assure the competency of the evidence from this procedure, the auditor should personally mail the request in his or her own return address envelope, and the response should be returned directly to the auditor by the bank. Bank confirmation requests should be sent to all banks in which the client has an account, including those that may have a zero balance at the end of the year.

Confirm Other Arrangements with Banks

Other arrangements with banks include such matters as lines of credit, compensating balances, and contingent liabilities. The arrangements for establishing a line of credit with a bank may require the borrower to maintain a cash balance with the bank. The amount may be an agreed-on-percentage of the amount borrowed, or it may be a specified dollar amount. The required minimum amount is referred to as a **compensating balance**. A contingent liability may exist when the client is the guarantor of a loan made by the bank to a third party.

If, after assessing inherent and control risk, the auditor believes such arrangements may exist, he or she should send a confirmation letter to the bank. The letter should specifically identify the information requested and be signed by the client. The AICPA has developed standard confirmation letters for the three arrangements identified above. Preferably, the letter should be sent to the bank official who is in charge of the client's relationship with the bank. Directing the letter to such an individual will expedite the confirmation process and enhance the quality of the evidence the auditor obtains. The auditor's request for information on line of credit and contingent liabilities does not require the respondent to make a detailed search of the bank's records.

Scan, Review, or Prepare Bank Reconciliations

Scanning, testing, or preparing a bank reconciliation establishes the correct cash in the bank balance at the balance sheet date. 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 normally 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

The working paper for an auditor review of a bank reconciliation prepared by the client (PBC) is illustrated in Figure 18-11.

When detection risk is low, the auditor may prepare the bank reconciliation using bank data in the client's possession. When detection risk is very low or the

Figure 18-11 ■ Review of Client-Prepared Bank Reconciliation

Bates Company				Prepared By: C.J.B. Date: 1/15/X2	
W/P Ref. A-1				Reviewed By: R.E.Z. Date: 1/25/X2	
Bank Reconciliation – City Bank – General Accounts					
December 31, 20X1					
(PBC)					
Acct # 110					
Bank Account No. 12345-642					
Balance per Bank					\$ 120,262.47 a
Deposits in Transit	Per books	Per bank			
	12–30	1–2	\$ 8,425.15	b	
	12–31	1–7	\$ 17,844.79	b	\$ 26,269.94 F
Outstanding Checks:		1047	\$ 225.94	b	
		1029	\$ 21,600.00	b	
		1435	\$ 47.25	b	
		1436	\$ 1,428.14	b	
		1437	\$ 1,000.00	b	
		1440	\$ 832.08	b	
		1441	\$ 41.08	b	\$ (25,174.49) F
Add NSF Check: R. Zim 12/29					\$ 200.00 c
Balance per Books					<u>\$ 121,557.92</u> F, d
					To A

F) Footed
a) Agreed to bank statement and bank confirmation
b) Traced to cutoff bank statement
c) Traced to bank statement and debit memo. Cash balance at year-end was overstated by \$200 and receivables were understated by the same amount. Immaterial. Pass further investigation.
d) Traced to general ledger

auditor suspects possible material misstatements, the auditor may obtain the year-end bank statement directly from the bank and prepare the bank reconciliation. To do so, the auditor must request the client to instruct the bank to send the bank statement and accompanying data (paid checks, debit memos, etc.) directly to the auditor. This procedure will prevent the client from making alterations of the data to cover any misstatements.

The evidence provided by a bank reconciliation alone is generally not considered sufficient to verify the balance of cash in bank because of uncertainties concerning the following two most important reconciling items: (1) deposits in transit and (2) outstanding checks. Such evidence is obtainable only by tracing these items to the bank statement in the next accounting period. The procedure of obtaining a bank cutoff statement is designed, in part, for this purpose. When the cutoff statement validates these and other reconciling items, the reliance that an auditor can place on a bank reconciliation is significantly enhanced.

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. Usually, the date is seven to ten business days following the end of the client's fiscal year.

The client must request the cutoff statement from the bank and instruct that it be sent directly to the auditor. On receipt of the cutoff statement, with enclosed canceled checks and bank memoranda, the auditor should:

- Trace all prior-year dated checks to the outstanding checks listed on the bank reconciliation
- Trace deposits in transit on the bank reconciliation to deposits on the cutoff statement
- Scan the cutoff statement and enclosed data for unusual items

The tracing of checks is designed to verify the list of outstanding checks. In this step, the auditor may also find that a prior-period check not on the list of outstanding checks has cleared the bank and that some of the checks listed as outstanding have not cleared the bank. The former may be indicative of an irregularity known as kiting, which is explained on page 869; the latter may be due to delays in (1) mailing the checks by the client, (2) depositing the checks by the payees, and (3) processing the checks by the bank. The auditor should investigate any unusual circumstances.

When the aggregate effect of uncleared checks is material, it may be indicative of an irregularity known as **window dressing**, which is a deliberate attempt to overstate a company's short-term solvency.¹ In such a case, the auditor should trace the uncleared checks to the check register and supporting documentation and, if necessary, make inquiries of the treasurer.

The tracing of deposits in transit to the cutoff statement is normally a relatively simple matter because the first deposit on the cutoff statement should be the deposit in transit shown on the reconciliation. When this is not the case, the auditor should determine the underlying circumstances for the time lag from the treasurer and corroborate his or her explanations.

In scanning the cutoff statement for unusual items, the auditor should be alert for such items as unrecorded bank debits and credits and bank errors and corrections.

Inasmuch as the auditor obtains the cutoff statement directly from an independent source outside the client's organization, it provides a high degree of competent corroborating information about the validity of the year-end bank reconciliation and the existence or occurrence, completeness, rights and obligations, and valuation or allocation assertions for cash in bank.

Tests of Details of Presentation and Disclosure

Cash should be correctly identified and classified in the balance sheet. For example, cash on deposit is a current asset. However, bond sinking fund cash is a long-term investment. In addition, there should be appropriate disclosure

¹ Assume at the balance sheet date, the client's balances show current assets of \$800,000 and current liabilities of \$400,000. If \$100,000 of checks to short-term creditors have been prematurely entered, the correct totals are current assets of \$900,000 and current liabilities of \$500,000, which results in a 1.8:1 current ratio instead of the reported 2:1.

of arrangements with banks such as lines of credit, compensating balances, and contingent liabilities. A bank overdraft is normally reported as a current liability.

The auditor determines the appropriateness of the statement presentation from a review of the draft of the client's statements and the evidence obtained from the foregoing substantive tests. In addition, the auditor should review the minutes of board of directors meetings and make inquiry of management for evidence of restrictions on the use of cash balances.

LEARNING CHECK

- 18-15** a. Identify three different tests of details of transactions that can be performed in auditing cash balances.
b. Which of these tests need not be performed when control risk pertaining to cash transactions and balances is low and the entity's bank accounts have been reconciled?
- 18-16** a. What is meant by the term *kiting*?
b. What procedures can the auditor use to detect kiting?
- 18-17** What precautions should the auditor take in counting cash on hand?
- 18-18** a. What is lapping?
b. What circumstance is conducive to lapping?
- 18-19** a. What precautions are taken by the embezzler to prevent detection of lapping?
b. What tests can the auditor use to detect lapping?
- 18-20** a. What types of information does the auditor seek to have confirmed on the standard form to confirm account balance information with financial institutions?
b. What assertions are addressed by the confirmation data?
- 18-21** a. What is a *compensating balance*?
b. What is the auditor's primary source of evidence about this item, and to what assertion does it pertain?
- 18-22** How may the auditor vary his or her work on bank reconciliations based on the applicable acceptable level of detection risk?
- 18-23** a. What safeguards should the auditor take in obtaining a bank cutoff statement?
b. For what purposes does the auditor use a bank cutoff statement?
- 18-24** Identify several considerations the auditor should make regarding management's presentation and disclosure of cash balances.

KEY TERMS

Bank confirmation, p. 872	Cash cutoff tests, p. 869
Bank cutoff statement, p. 875	Compensating balance, p. 874
Bank reconciliation, p. 874	Kiting, p. 869
Bank transfer schedule, p. 869	Lapping, p. 871
Cash counts, p. 870	Window dressing, p. 876

OTHER RELATED SERVICES

Audit Decision 12

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

Not every company follows the practices of most well-managed companies of forecasting cash balances and developing policies of the investment of surplus cash. CPAs understand the opportunities available to companies to invest surplus cash for short periods of time when it is not needed to pay current obligations, sometimes even on an overnight basis. Furthermore, electronic spreadsheets make it easier for CPAs to develop models to forecast cash balances on a month-by-month basis. Following are some important value-added opportunities that CPAs may provide using the knowledge obtained during the audit of marketable securities and cash balances.

- Determine key assumptions regarding cash collections and the payment of operating expenses that influence the forecasting of cash balances.

cash balances in freefall

An outside director of a not-for-profit approached a CPA friend with a problem. The chairwoman of the board of directors was concerned about what she had seen in recent monthly financial statements. The not-for-profit was a social service agency that subcontracted with the state and county to deliver three programs that provided services to children, services to women moving from the state's corrections program back to the community, and services to the elderly. She stated that in recent months the entity's cash balances "were in freefall." Several months ago, they had over \$500,000 in cash and investments. Now most of it was gone, and the chief accounting officer was talking with her about the need to draw on a line-of-credit with the bank to pay bills, for the first time in over three years. Internal controls were good, and the entity received only minor reportable conditions associated with the annual audit that was just completed.

The CPA volunteered to perform a free consulting engagement to help her friend identify the problem. The CPA identified two major problems that caused the decline in cash balances.

First, the entity agreed to contract changes with the state and county whereby it would be reimbursed for the services it provided at a rate per person served rather than the previous monthly lump-sum amount. The previous lump sum was sufficient to cover the entity's fixed payroll and operating costs, but now that the entity was being reimbursed on a per-person basis, some months the reimbursement from the state or county was insufficient to cover the organization's costs.

Second, the entity had been paid its lump sum by the state or county in time to use the cash to pay its payroll and operating expenses. Now the organization had to incur the costs, provide services, and then bill the state or county for each person served. Rather than receiving cash before paying for its costs, it delivered services, billed for services, and waited four to six weeks for cash to come in. Furthermore, many of the managers who were good at providing social services were slow to prepare their billings to the state or county, delaying cash flow for a longer period.

The auditor focused on internal controls over cash, rather than on the entity's business practices. The internal controls were strong, while the entity's business practices were weak. During the subsequent year the audit was put up for bid, and the CPA who recommended that the social service agency negotiate an advance from the state and county to cover its cash flow needs won the engagement. In the subsequent years the CPA helped train the organization's managers to behave more like a for-profit organization as it now had heavy fixed costs that had to be recovered on a fee for each person served.

- Assist management in the development of models to forecast cash balances, needed borrowing, or potential surplus cash balances available for investment.
- Identify opportunities for changes in business practices, such as changes in credit policy or changes in inventory management, which will improve cash flow.
- Assist management in developing policies for the short-term investment of excess cash.
- Identify opportunities for improving the rate of return on short-term investments of excess cash.

Each of these steps can help an entity improve its cash management practices.

FOCUS ON AUDIT DECISIONS

This chapter focuses on the audit of two very liquid assets: short-term and long-term investments and cash. Figure 18-12 summarizes the audit decisions discussed in Chapter 18 and provides page references indicating where these decisions are discussed in more detail.

Figure 18-12 ■ Summary of Audit Decisions Discussed in Chapter 18

Audit Decision	Factors That Influence the Audit Decision	Chapter References
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?	Short-term and long-term investments include investing in the debt and equity securities of another entity. This audit area also includes related interest and dividend income. Figure 18-1 uses the framework discussed in Chapter 6 to develop the specific audit objectives that are tailored to short-term and long-term investments. In order to collect sufficient, competent evidence, the auditor must obtain evidence for each audit objective.	pp. 849–850
D2. What audit planning decisions should be made when developing an audit program for the audit of short-term and long-term investments?	<p>A key aspect of understanding an entity's investments in debt and equity securities relates to its ability to generate free cash flows. The ability to generate free cash flow may be seasonal and depends on an entity's competitive advantage in the marketplace.</p> <p>Each company's ability to generate cash flow is so unique that industry information may not be a good benchmark for comparing a company. It may be more effective to develop expectations using cash budgets or forecasts.</p> <p>The most significant inherent risk revolves around the classification of investments as held-to-maturity, available-for sale, or trading securities. Additional inherent risks relate to the fact that investments may be susceptible to misappropriation, and some investments should be valued at fair value.</p> <p>The chapter discussion identifies specific controls associated with four functions: (1) authorizing investment transactions, (2) receiving or delivering securities, (3) recording transactions, and (4) settling transactions. The suggested controls are similar to those suggested in previous chapters with modifications for documents and records that are tailored to investments in debt and equity securities.</p>	pp. 850–854

(continues)

Figure 18-12 ■ (Continued)

Audit Decision	Factors That Influence the Audit Decision	Chapter References
<p>D3. What factors are involved in determining an acceptable level of tests of details risk for short-term and long-term investments?</p>	<p>Figure 18-2 outlines one possible preliminary audit strategy for each assertion for investments. The audit of short-term investments often focuses on tests of balances due to significant turnover in these accounts. However, the audit of long-term investments may have low turnover and focus on tests of transactions.</p>	<p>pp. 854–856</p>
<p>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?</p>	<p>This section uses the framework developed in Chapter 12 to design substantive tests for the investing cycle. Figure 18-3 summarizes substantive tests for investments. It summarizes the initial procedures, analytical procedures, tests of details of transactions, tests of details of balances, tests of details of accounting estimates, and tests of details of disclosures relevant to the investing cycle. The chapter discussion explores these tests in more detail.</p>	<p>pp. 856–862</p>
<p>D5. What is the relationship of the transaction cycles to cash balances, and how are specific audit objectives developed for cash balances?</p>	<p>Figure 18-5 provides a graphic illustration of how the other transaction cycle interacts with cash. The revenue cycle, expenditure cycle, financing cycle, investing cycle, and personnel services cycle all have transactions that flow through cash balances. Controls over these other cycles are important to controls over cash. Figure 18-6 presents specific audit objectives for cash balances.</p>	<p>pp. 862–864</p>
<p>D6. What audit planning decisions should be made when developing an audit program for the audit of cash balances?</p>	<p>Cash balances are more related to an entity’s cash management practices than to specific industry issues. However, when a company is profitable and generating free cash flow, it is more likely that excess cash will be invested in short-term and long-term investments.</p> <p>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.</p> <p>The high volume of transactions and the susceptibility to theft contribute to a significant level of inherent risk for existence or occurrence and completeness assertions. 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.</p> <p>Cash receipts and disbursements often represent routine transactions that can be controlled by a sound system of internal controls. 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. Internal controls over cash receipts and cash disbursements were previously discussed in Chapters 14 and 15, respectively.</p>	<p>pp. 864–865</p>

(continues)

Figure 18-12 ■ (Continued)

Audit Decision	Factors That Influence the Audit Decision	Chapter References
D7. What factors are involved in determining acceptable level of tests of details risk for cash balance assertions?	Figure 18-7 outlines one possible preliminary audit strategy for each assertion for cash balances. Audit strategies focus on the audit of cash balances and are influenced by the entity's system of internal controls.	pp. 865–868
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?	This section of the chapter uses the framework developed in Chapter 12 to develop substantive tests for each specific audit objective in the expenditure cycle. These are summarized in Figure 18-8 and explained in depth in the chapter discussion.	pp. 868–869
D9. What is the fraud known as kiting, and how can the auditor detect it?	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 an irregularity known as <i>kiting</i> . To test for kiting a auditor needs to perform substantive tests of bank transfers before and after year-end. Figure 18-9 provides examples of bank transfers that involve kiting (examples 3 and 4).	pp. 869–871
D10. What is the fraud known as lapping, and how can the auditor detect it?	<i>Lapping</i> is fraud that results in the deliberate misappropriation of cash receipts. Conditions conducive to lapping exist when an individual who handles cash receipts also maintains the accounts receivable ledger, and the individual usually credits one customer's cash receipt to a customer from whom funds were misappropriated. The chapter discussion explains how lapping is often detected.	pp. 871–872
D11. What are the roles of confirmations and the use of a bank cutoff statement in the audit of cash balances?	Bank confirmations are an important tool when testing the existence of cash balances. If internal controls are poor, an auditor may request a bank cutoff statement. A bank cutoff statement is a bank's statement as of a date subsequent to the balance sheet date. It is used to obtain evidence of the validity of items shown on a client's bank reconciliation.	pp. 872–877
D12. How might the auditor use the knowledge obtained during the audit of investments and cash balances to deliver other services to clients?	When auditing investments and cash balances, auditors may recognize opportunities to improve cash management activities. The chapter discussion addresses a number of activities that may help an entity improve its cash management practices.	pp. 878–879

objective questions

Objective questions are available for the student at www.wiley.com/college/boynton

comprehensive questions

18-25 **(Controls and substantive tests for investment transaction)** You have been assigned to audit the “investments” account of one of your firm’s older clients, the D Company. During the prior year, your client received more than \$1 million from the sale of all its stock in a subsidiary. The proceeds from this sale were promptly invested in time certificates of deposit (CDs) having various maturities. More than one year has elapsed since the sale of the stock, and your client continues to invest the funds in CDs. Investment decisions are made by the company treasurer, who also is responsible for custody of the CDs.

During the current year, D’s treasurer obtained \$100,000 from the surrender of a CD at maturity and invested the proceeds in another six-month certificate having an interest rate of 10 percent. This transaction was recorded on the books of the company as being for a CD bearing an interest rate of 8 percent. At the end of the six months, the treasurer redeemed this CD for its \$105,000 maturity value. On the books of the company, the transaction was recorded as having been for \$104,000, and the treasurer deposited that amount in the company’s bank account prior to reinvesting the proceeds in another security.

Required

- a. What internal controls could have prevented or permitted detection of the treasurer’s action?
- b. What substantive tests could you perform to discover this irregularity?

18-26 **(Substantive tests of investment balances)** In verifying investing cycle balances in the Travis Company, C.J. Kupec, CPA, recognizes that the following misstatements may occur or exist:

1. A mathematical error is made in accruing interest earned.
2. A 25 percent common stock investment in an affiliated company is accounted for on the cost basis.
3. Securities held by an outside custodian are in the treasurer’s name.
4. Securities on hand at the beginning of the year are diverted to personal use in July and are replaced in December.
5. An authorized purchase is recorded at cost, and the broker’s fee is expensed.
6. Ten shares of stock reported to be on hand are missing.
7. Marketable equity securities are reported at cost, which is above market.
8. The schedule of marketable securities does not reconcile to the general ledger accounts.
9. Gain on a sale of securities is reported net of taxes.
10. Securities pledged as collateral on a bank loan are not disclosed.

Required

- a. Identify the substantive test that should detect each misstatement.
- b. For each test, indicate the financial statement assertion(s) to which it pertains.
- c. Indicate the type of evidence obtained from the substantive test (i.e., physical, confirmation, documentary, written representation, mathematical, oral, or analytical). (Use a tabular format for your answers with one column for each part.)

18-27 **(Investments—audit objectives, confirmations, disclosures)** As a result of highly profitable operations over a number of years, Eastern Manufacturing Corporation accumulated a substantial investment portfolio. In the audit of the financial statements for the year ended December 31, 20X0, the following information came to the attention of the corporation’s independent auditor (CPA):

1. The manufacturing operations of the corporation resulted in an operating loss for the year.
2. In 20X0, the corporation placed the securities making up the investment portfolio with a financial institution that will serve as custodian of the securities. Formerly, the securities were kept in the corporation's safe deposit box in the local bank.
3. On December 22, 20X0, the corporation sold and then repurchased on the same day a number of securities that had appreciated greatly in value.

Management stated that the purpose of the sale and repurchase was to establish a higher cost and book value for the securities and to avoid the reporting of a loss for the year.

Required

- a. List the audit objectives of the CPA's examination of the investment account.
- b. Under what conditions would the CPA accept a confirmation of the securities on hand from the custodian in lieu of inspecting and counting the securities?
- c. What disclosure, if any, of the sale and repurchase of the securities would the CPA recommend for the financial statements?

AICPA

- 18-28 **(Evaluation of working paper for investments)** The schedule on page 886 was prepared by the controller of World Manufacturing, Inc., for use by the independent auditors during their audit of World's year-end financial statements. All procedures performed by the audit assistant were noted in the "Legend" section at the bottom. The schedule was properly initialed, dated, and indexed, and then submitted to a senior member of the audit staff for review. Internal control was reviewed and is considered satisfactory.

Required

- a. What information that is essential to the audit of marketable securities is missing from this schedule?
- b. What are the essential substantive tests that were noted as having been performed by the audit assistant?

AICPA

- 18-29 **(Audit program for cash balances)** MLG Company's auditor received directly from the banks confirmations and cutoff statements with related checks and deposit tickets for MLG's three general-purpose bank accounts. The auditor determined that control risk for cash balance assertions was 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)

- 18-30 **(Cash irregularities)** The Patricia Company had poor internal control over its cash transactions. Facts about its cash position at November 30, 20X0, were as follows:

The cashbook showed a balance of \$18,901.62, which included undeposited receipts. A credit of \$100 on the bank's records did not appear on the books of the company. The balance per bank statement was \$15,550. Outstanding checks were: #62 for \$116.25, #183 for \$150, #284 for \$253.25, #8621 for \$190.71, #8623 for \$206.80, and #8632 for \$145.28.

The cashier abstracted all undeposited receipts in excess of \$3,794.41 and prepared the reconciliation shown on page 887:

World Manufacturing Inc. Marketable Securities Year Ended December 31, 20X1

Description of Security	YR.	%	DUE	Serial No.	Face Value of Bonds	Gen. Ledger 1/1	Purch. in 20X1	Sold in 20X1	Cost	Gen. Ledger 12/31	12/31 Market	Dividend and Interest			
												Pay Date(s)	Amt. Rec	Accruals 12/31	
CORP. BONDS															
A	6	91		21-7	10,000	9,400 <i>a</i>				9,400	9,400	1/15	300 <i>b, d</i>		275
D	4	83		73-0	30,000	27,500 <i>a</i>				27,500	26,220	7/15	300 <i>b, d</i>		100
G	9	98		16-4	5,000	4,000 <i>a</i>				4,000	5,080	12/1	1,200 <i>b, d</i>		188
Rc	5	85		08-2	70,000	66,000 <i>a</i>		57,000 <i>b, c</i>	66,000	100,000	101,250	7/1	5,000 <i>b, d</i>		5,000
Sc	10	99		07-4	100,000	106,900	100,000	57,000	66,000	140,900	141,650	7/1	7,250		5,563
						<i>a, f</i>	<i>f</i>	<i>f</i>	<i>f</i>	<i>f, g</i>	<i>f</i>		<i>f</i>		<i>f</i>
STOCKS															
P 1,000 shs. Common					7,500 <i>a</i>					7,500	7,600	3/1	750 <i>b, d</i>		
												6/1	750 <i>b, d</i>		
												9/1	750 <i>b, d</i>		
												12/1	750 <i>b, d</i>		250
U 50 shs. Common					9,700 <i>a</i>					9,700	9,800	2/1	800 <i>b, d</i>		
												8/1	800 <i>b, d</i>		667
						<u>17,200</u>				<u>17,200</u>	<u>17,400</u>		<u>4,600</u>		<u>917</u>
						<i>a, f</i>				<i>f</i>	<i>f, g</i>		<i>f</i>		<i>f</i>

Legends and comments relative to above:

a = Beginning balances agreed to 19X0 working papers.

b = Traced to cash receipts.

c = Minutes examined (purchase and sales approved by the board of directors).

d = Agreed to 1099 (tax form).

e = Confirmed by tracing to broker's advice.

f = Totals footed.

g = Agreed to general ledger.

Balance per books, November 30, 20X2		\$ 18,901.62
Add: Outstanding Checks		
8621	\$ 190.71	
8623	\$ 206.80	
8632	\$ 145.28	\$ 442.79
		<hr/>
		\$ 19,344.41
Less Undeposited receipts		\$ (3,794.41)
Balance per bank, November 30, 20X2		\$ 15,500.00
Deducted: Unrecorded credit		\$ 100.00
		<hr/>
True cash, November 30, 20X2		\$ 15,450.00

Required

- Prepare a working paper showing how much the cashier abstracted.
- How did he attempt to conceal his theft?
- Using only the information given, name two specific features of internal control that were apparently lacking.

AICPA

- 18-31 **(Substantive tests for cash balances)** You are the in-charge accountant examining the financial statements of the Gutzler Company for the year ended December 31, 20X0. During late October 20X0, you, with the help of Gutzler's controller, completed an internal control questionnaire and prepared the appropriate memoranda describing Gutzler's accounting procedures. Your comments relative to cash receipts are as follows:

All cash receipts are sent directly to the accounts receivable clerk with no processing by the mail department. The accounts receivable clerk keeps the cash receipts journal, prepares the bank deposit slip in duplicate, posts from the deposit slip to the subsidiary accounts receivable ledger, and mails the deposit to the bank.

The controller receives the validated deposit slips directly (unopened) from the bank. He also receives the monthly bank statement directly (unopened) from the bank and promptly reconciles it.

At the end of each month, the accounts receivable clerk notifies the general ledger clerk by journal voucher of the monthly totals of the cash receipts journal for posting to the general ledger.

Each month, with regard to the general ledger cash account, the general ledger clerk makes an entry to record the total debits to cash from the cash receipts journal. In addition, the general ledger clerk on occasion makes debit entries in the general ledger cash account from sources other than the cash receipts journal (e.g., funds borrowed from the bank).

In the audit of cash receipts you have already performed certain of the standard auditing procedures listed below. The extent to which these procedures were performed is not relevant to the question.

- Total and cross-total all columns in the cash receipts journal.
- Trace postings from the cash receipts journal to the general ledger.
- Examine remittance advices and related correspondence to support entries in the cash receipts journal.

Required

Considering Gutzler's internal control over cash receipts and standard auditing procedures already performed, list all other auditing procedures and reasons therefore which should be performed to obtain sufficient audit evidence regarding cash receipts. Do not discuss the procedures for cash disbursements and cash balances. Also do not discuss the extent to

which any of the procedures are to be performed. Assume adequate controls exist to assure that all sales transactions are recorded. Organize your answer sheet as follows:

OTHER AUDIT PROCEDURES	REASONS FOR OTHER AUDIT PROCEDURES

AICPA

18-32 **(Bank transfer schedule; kiting)** The LMN Company maintains three bank accounts: City Bank-Regular, City Bank-Payroll, and Metro Bank-Special. Your analysis of cash disbursements records for the period June 23 to July 6 reveals the following bank transfers:

CHECK NO.	DATE OF CHECK	BANK DRAWN ON	PAYEE	AMOUNT
2476	June 23	Regular	Payroll	\$100,000
2890	June 25	Regular	Payroll	200,000
3140	June 28	Regular	Special	100,000
A1006	June 29	Special	Payroll	50,000
A1245	June 30	Special	Regular	25,000
3402	June 30	Regular	Special	125,000

You determine the following facts about each of the first five checks: (1) the date of the cash disbursements journal entry is the same as the date of the check, (2) the payee receives the check two days later, (3) the payee records and deposits the check on the day it is received, and (4) it takes five days for a deposited check to clear banking channels and be paid by the bank on which it is drawn. Check 3402 was not recorded as a disbursement until July 1. This check was picked up by the payee on the date it was issued, and it was included in the payee's after-hours bank deposit on June 30.

Required

- a. What are the purposes of the audit of bank transfers?
 - b. Prepare a bank transfer schedule as of June 30 using the format illustrated in Figure 18-9.
 - c. Prepare separate adjusting entries for any checks that require adjustment.
 - d. In the reconciliation for the three bank accounts, indicate the check numbers that should appear as (1) an outstanding check or (2) a deposit in transit.
 - e. Which check(s) may be indicative of kiting?
- 18-33 **(Procedures to detect lapping)** During the year, Strang Corporation began to encounter cash flow difficulties, and a cursory review by management revealed receivable collection problems. Strang's management engaged Stanley, CPA, to perform a special investigation. Stanley studied the billing and collection cycle and noted the following:

The accounting department employs one bookkeeper who receives and opens all incoming mail. This bookkeeper is also responsible for depositing receipts, filing remittance advices on a daily basis, recording receipts in the cash receipts journal, and posting receipts in the individual customer accounts and the general ledger accounts. There are no cash sales. The bookkeeper prepares and controls the mailing of monthly statements to customers.

The concentration of functions and the receivable collection problems caused Stanley to suspect that a systematic defalcation of customers' payments through a delayed posting of remittances (lapping of accounts receivable) is present. Stanley was surprised to find that no customers complained about receiving erroneous monthly statements.

Required

Identify the procedures that Stanley should perform to determine whether lapping exists. Do not discuss deficiencies in the internal control structure.

AICPA

cases

- 18-34 **(Substantive tests of investment balances)** The Jones Company, located in Chicago, has been your client for many years. The company manufactures light machinery and has a calendar year closing. At December 31, 20X1, and 20X2, the following items appeared in the accounts applicable to investment securities. Investments in securities represent approximately 8 percent of total assets. Income from securities represents approximately 3 percent of income before federal income tax.

BALANCE SHEET ACCOUNTS	20X0	20X1
U.S. government certificates of indebtedness, 3% series D dated May 15, 20X0, due May 15, 20X2 (at cost)	\$300,000	\$300,000
Available-for-sale equity securities (at fair value):		
50 shares of AP Company	5,800	5,000
100 shares of UC Corporation	—	8,000
75 shares of IC Corporation	12,000	—
Investment in a 60% owned subsidiary—SUB, Inc.	50,000	50,000
Unrealized gain (loss) on available-for-sale securities (equity account)	1,450	(1,075)
Accrued interest receivable	1,125	1,125
INCOME STATEMENT ACCOUNTS		
Interest income	9,000	9,000
Gain (loss) on sale of securities	(–2,000)	3,000
Dividend income	13,000	14,000

The U.S. government securities shown above are held at the Utah Banking Company. The AP Company securities are held in the Jones Company's safe, and the UC Corporation securities are in a safety deposit box at the Chicago Bank Company, which is the company's bank. Access to the company's safe is limited to the treasurer or his assistant. Access to the safety deposit box is limited to any two of the treasurer, the assistant treasurer, or the controller. The securities of SUB, Inc., are also held by the Chicago Bank Company as collateral for a loan that the Jones Company has outstanding. SUB, Inc., has a June 30 closing and is audited by your firm.

Your tests of internal control indicate unusual strengths in the areas of cash receipts and cash disbursements. The treasurer is responsible for the physical control of securities, whereas the controller is responsible for the recording of all transactions affecting securities. An assistant to the assistant controller maintains an investment ledger that shows the name of each investment, the number of shares held or the face value of bonds, the date of purchase and sale, if applicable, the cost, the physical location of the securities, and the income thereon. This person prepares monthly statements of securities on hand showing their description and cost. All purchases and sales of securities are authorized by the company's finance committee. The following audit program has been prepared for the examination of securities at December 31, 20X1.

1. *U.S. Government Securities*
 - a. Prepare a schedule of the securities at December 31, 20X1.
 - b. Obtain direct confirmation from the Utah Banking Company as to description and amount of securities held.

- c. Trace the confirmation to the schedule and so indicate.
 - d. Verify the interest earned for the year and accrued interest receivable at December 31, 20X1.
 - e. Trace the appropriate totals to the general ledger accounts.
2. *Available-for-Sale Equity Securities*
- a. Prepare an analysis of the securities account for the year under audit, including the market value of the securities at December 31, 20X1.
 - b. Count AP Company securities at the company's office at the close of business on December 31, 20X1. Inspection of the securities should be in the presence of client's representative. Note the time of count, name of client's representative, and name of the auditor on the count sheet. Accompanied by the client's representative, inspect the UC Corporation securities at the Chicago Bank Company. Inspection should be completed at the close of business on December 31, 20X1. The same information should be shown on this count sheet as is indicated to be appropriate for the count sheet mentioned above. The count sheets should show the number of shares, the full name of security, and the type of security (preferred or common shares).
 - c. Vouch purchases and sales by reference to brokers' advices. Compare authorizations of the finance committee to the schedule.
 - d. Compare dividends received for the year with a published dividend record.
 - e. Verify the recorded gain or loss on sale of securities.
 - f. Trace the appropriate totals on the schedule to the general ledger accounts.
3. *Investment in 60% Owned Subsidiary-SUB, Inc.*
- a. Request the Chicago Bank Company to confirm that it holds the securities for SUB, Inc., as collateral for a loan. The amount payable to the bank may be confirmed concurrently.
 - b. Review the monthly statements of SUB, Inc., since your latest examination and compare them with the audited statements at June 30. Obtain an explanation of all unusual transactions and fluctuations.
 - c. Discuss the December 31, 20X1, financial statements with the management of the company. Inquire as to material amounts not recorded.
 - d. Establish that the intercompany accounts are in agreement at December 31.
 - e. Record the company's equity in the assets and net income of SUB, Inc., at December 31, 20X1.

Required

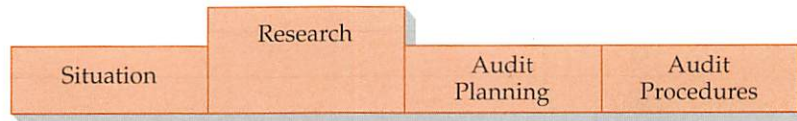
- a. List the substantive tests that you believe are appropriate and identify the assertions to which each test relates.
- b. List the substantive tests that you believe are inappropriate and give the reasons for your conclusion.
- c. List additional substantive tests, if any, that you believe are appropriate and state why.

professional simulation

Situation	Research	Audit Planning	Audit Procedures
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The Vane Corporation is a manufacturing concern that has been in business for the past 18 years. During this period, the company has grown from a very small family-owned operation to a medium-sized manufacturing concern with several departments. Despite this

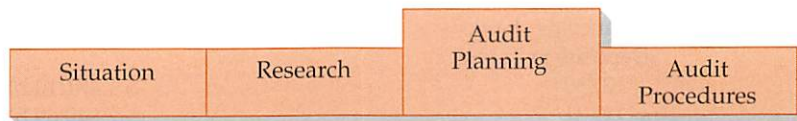
growth, a substantial number of the procedures employed by Vane Corporation have been in effect since the business was started.



Generally accepted accounting principles require that management’s intent and ability be considered in valuing certain securities; for example, whether —

- Debt securities are classified as held-to-maturity and reported at their cost depend on management’s intent and ability to hold them to their maturity.
- Equity securities are reported using the equity method depend on management’s ability to significantly influence the investee.
- Equity securities are classified as trading or available-for-sale depend on management’s intent and objectives in investing in the securities.

Cut and paste the U.S. auditing standards sections that explain the evidence that an auditor should obtain to evaluate assertions about securities based on management’s intent and ability.



You have been asked to prepare a training session for new audit staff on the audit of cash balances. You have been asked to explain how the audit of cash balances at year-end will differ if the client has good internal controls over cash transactions and bank balances versus a client that has weak internal controls over cash transactions and bank balances. Prepare a memo outlining contrasting the audit of cash balances at year-end for each of these two situations.

To: Audit File
 Re: Staff Training for Audit of Cash Balances
 From: CPA Candidate

GOOD INTERNAL CONTROLS OVER CASH TRANSACTIONS AND CASH BALANCES	WEAK INTERNAL CONTROLS OVER CASH TRANSACTIONS AND CASH BALANCES

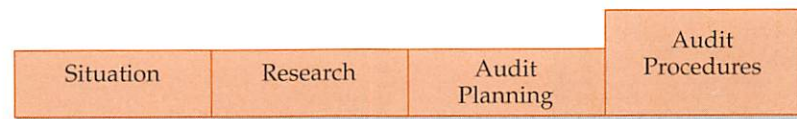


Exhibit 18-35 provides a working paper (lead schedule) for the audit of Vane’s bank balance. Explain the auditing procedures that should be performed associated with the legend identified as a) through i). Use the following format.

LEGEND	AUDIT PROCEDURE
a)	
b)	
c)	
d)	
e)	
f)	
g)	
h)	
i)	

EXHIBIT 18-35 AUDIT OF CASH IN BANK

Vane Corporation		W/P Ref: B-1
Cash in Bank	Prepared by: <i>CJG</i>	Date: 2/4/X4
December 31, 20X3	Reviewed By: <i>RCP</i>	Date: 2/12/X4
Balance per bank		\$ 18,375.91 a)
Deposits in Transit		
12/30	\$ 1,471.10 b)	
12/31	\$ 2,840.69 b)	\$ 4,311.79 i)
Subtotal		\$ 22,687.70 i)
Outstanding checks		
837	\$ 6,000.00 c)	
1941	\$ 671.80	
1966	\$ 320.00	
1984	\$ 1,855.42 c)	
1985	\$ 3,621.22 c)	
1987	\$ 2,576.89 c)	
1991	\$ 4,420.88 c)	\$ (19,466.21) i)
Subtotal		\$ 3,221.49 i)
NSF check returned 12/29		\$ 200.00 d)
Bank charges		\$ 550.00 e)
Error Check No. 1932		\$ 148.10 f)
Customer note collected by the bank (\$2,750 plus \$275 interest)		\$ (3,025.00) g)
Balance per books		\$ 550.09 h)
		i)