Auditing
A Practical Approach

Third Canadian Edition

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Chapter 12

AUDITING CASH AND INVESTMENTS

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LEARNING OBJECTIVES (1 of 2)

1. Identify the audit objectives applicable to cash
2. Discuss considerations relevant to determining the audit strategy for cash
3. Design and execute an audit program for cash balances
4. Describe special considerations when auditing cash balances, including lapping, petty cash funds, and imprest bank accounts

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LEARNING OBJECTIVES (2 of 2)

5. Identify the audit objectives applicable to investments
6. Discuss considerations relevant to determining the audit strategy for investments
7. Design and execute an audit program for investments
8. Explain the special considerations applicable to the audit of investments in subsidiaries, associates and joint ventures

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Audit Objectives

- Key issues for cash and investments include:
  - cash exists and is owned by the client and that all cash transactions at the end of the reporting period are complete and properly disclosed
  - Investments exist, are owned, and properly recorded, valued, and disclosed

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Audit Objectives: Cash (1 of 5)

- Cash is normally comprised of one or a combination of the following:
  - Cash balances at the bank or similar institutions
  - Cash on hand
  - Cash equivalents (highly liquid investments convertible to cash within three months) may be included with cash in the balance sheet

Audit Objectives: Cash (2 of 5)

- Note internal control considerations and related audit objectives for cash receipts and payments were covered in Chapters 9 and 10
- The next slide(s) contain sample audit objectives for cash balances

Audit Objectives: Cash (3 of 5)

Transaction and Related Disclosure Objectives	
Occurrence (**OE**)	Recorded receipt and payment transactions represent cash inflows and outflows during the period (**OE1**).
Completeness (**C**)	All cash inflows and outflows made during the period have been recorded (**C1**).
Accuracy (**AV**)	Payments and receipts are properly (accurately) recorded (**AV1**).
Cut-off (**CO**)	Year-end transfers of cash between banks and bank accounts are recorded in the proper period (**CO1**).
Classification (**D**)	Payments and receipts are recorded in the correct accounts (**D1**).
Presentation (**D**)	Cash inflows and outflows are appropriately aggregated or disaggregated, clearly described, and the related disclosures are relevant and understandable (**D2**).

Selected specific audit objectives for cash balances

Audit Objectives: Cash (4 of 5)

Account Balance and Related Disclosure Objectives	
Existence (**OE**)	Recorded cash balances exist at the end of the reporting period (**OE2**). Lines of credit, loan guarantees, and other restrictions on cash balances are appropriately disclosed (**OE3**).
Rights and obligations (**RO**)	The entity has legal title to all cash balances shown at the end of the reporting period (**RO1**).
Completeness (**C**)	Recorded cash balances include the effects of all cash transactions that have occurred (**C2**). Cash balances are properly identified and included in the balance sheet (**C3**).

Selected specific audit objectives for cash balances

Audit Objectives: Cash (5 of 5)

Account Balance and Related Disclosure Objectives	
Accuracy, valuation and allocation (**AV**)	Recorded cash balances are realizable at the amounts stated on the balance sheet and agree with supporting schedules (**AV2**). Cash balances are disclosed accurately and at appropriate amounts (**AV3**).
Classification (**D**)	Cash balances are recorded in the correct accounts (**D3**).
Presentation (**D**)	Cash balances are appropriately aggregated or disaggregated, clearly described, and the related disclosures are relevant and understandable. (**D4**).

Selected specific audit objectives for cash balances

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Audit Strategy: Cash (1 of 11)

- Cash is vital to the survival of the business as a going concern
- Cash has a materiality that is greater (relative to its balance) than any other account
- The next slide illustrates the effect of different transaction cycles on the cash balance

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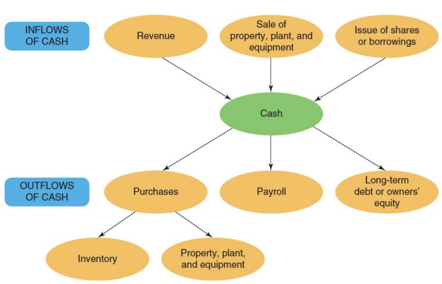
Audit Strategy: Cash (2 of 11)



The effects of major accounting transactions on cash

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Audit Strategy: Cash (3 of 11)

- High volume of transactions contributes to a high level of inherent risk, particularly existence and completeness
- Nature of cash makes it susceptible to theft
- When planning the audit it is necessary to consider the effectiveness of control procedures

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Audit Strategy: Cash (4 of 11)

- The auditor needs to have an understanding of the procedures for maintaining accountability over cash, in order to design the detailed substantive tests
- The main procedures are:
  - independently performed bank reconciliations
  - the use of imprest accounts

Audit Strategy: Cash (5 of 11)

- An imprest petty cash fund is established by transferring a specified amount of cash to a petty cash box
- When cash is used from the petty cash fund, an authorized voucher is placed in the petty cash box
- When cash get low the vouchers are used as support for a cheque requisition to replenish the fund

Audit Strategy: Cash (6 of 11)

- Typical control procedures include:
  - Fund should be maintained at the pre-determined level
  - Fund should be in custody of one person
  - Fund should be kept secured and stored in a safe place
  - Payments from the fund should be small amounts with supporting documentation

Audit Strategy: Cash (7 of 11)

- Typical control procedures include (continued):
  - The fund should not be mingled with other cash
  - Replenishment should be based upon a review of documentation
  - These supporting documents should be stamped paid upon payment

Audit Strategy: Cash (8 of 11)

- Typical control procedures over an imprest bank account include:
  - One person should be authorized to sign cheques drawn on the account
  - Only payroll cheques, dividends etc. should be written against the account

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Audit Strategy: Cash (9 of 11)

- Typical control procedures over an imprest bank account include (continued):
  - Each pay/dividend period, a cheque for the total net amount should be deposited in the imprest bank account
  - The imprest bank account should be reconciled each month

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Audit Strategy: Cash (10 of 11)

- The audit strategy is to concentrate on verifying the account balances and the approach is mainly substantive
- Main substantive audit procedures
  - Audit the bank reconciliation
  - Reconcile the balance to the confirmation from the bank

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Audit Strategy: Cash (11 of 11)

- *The auditor should be aware of the possibility of fraud as cash is more susceptible to fraud than other areas and consequently this increases inherent risk*

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Substantive Procedures for Cash Balances

- Need to consider detection risk, namely the risk that an auditor's substantive procedures will not detect any misstatements that occur and that are not prevented or detected by the internal control system

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Substantive Procedures for Cash Balances

- *The acceptable level of detection risk is set as low because of the significance of cash to the entity's liquidity and the controls usually placed over it*
- *The next slide(s) contain a sample of possible substantive procedures*

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Tests of Balances

- Five commonly used substantive tests for cash balances are:
  - confirming bank balances
  - confirming other arrangements with banks
  - verifying bank reconciliations
  - obtaining and using the subsequent period's bank statement
  - counting cash on hand

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Confirming Bank Balances (1 of 3)

- Bank confirmations: a letter/form sent directly to all the banks with whom the client has a relationship, looking for information about:
  - Account balances
  - Securities
  - Loan documents
  - Other information including contingent liabilities

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Confirming Bank Balances (2 of 3)

- Bank confirmation requests are sent out on every audit and include the clients signature authorizing the bank to complete the form
- Confirmation provides evidence on the existence assertion

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Confirming Bank Balances (3 of 3)

- They also provide some evidence for the valuation assertion for cash in that the confirmed balance is used in arriving at the cash balance at the end of the period
- Refer to the next slide for an example of a bank confirmation audit request

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Verifying the Bank Reconciliation (1 of 2)

- This testing verifies that the balance that has been confirmed with the bank agrees with the bank balance as per the client's records

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Verifying the Bank Reconciliation (2 of 2)

- Audit steps
  - Check the mathematical accuracy and compare with the general ledger
  - Verify the bank balance per the bank confirmation with the bank balance per the reconciliation
  - Trace outstanding cheques or direct transfers on the bank reconciliation to the subsequent period's bank statement
  - Verify any bank charges or errors on the reconciliation with supporting documentation

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Obtaining and Using the Subsequent Period's Bank Statement

- The auditor should:
  - trace all cheques or direct transfers dated in the previous financial year to the unpresented cheques or transfers listed on the bank reconciliation
  - trace deposits in transit on the bank reconciliation to deposits on the statement
- *Need to also scan the statement for unusual items such as large transfers close to year end*

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Counting Cash on Hand (1 of 2)

- Cash on hand consists of undeposited cash receipts and change

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Counting Cash on Hand (2 of 2)

- During the count, the auditor should:
  - control all cash and negotiable instruments held by the entity 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 funds
  - ascertain that all undeposited cheques are payable to the order of the entity, either directly or through endorsement

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Special Considerations for Cash Balances (1 of 4)

- Lapping is a deliberate irregularity, concealing the misappropriation of cash by using subsequent cash receipts to conceal the original misappropriation
- Conditions conducive to lapping exist when the same person handles cash receipts and maintains the AR ledger

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Special Considerations for Cash Balances (2 of 4)

- Three common procedures to detect lapping include:
  - Confirm AR on a surprise basis at an interim date
  - Make a surprise cash count
  - Compare the details of cash receipts journal entries with the details of corresponding daily deposit slips

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Special Considerations for Cash Balances (3 of 4)

- The balance of petty cash is typically not material
- Majority of audits do not involve the audit of petty cash
- When auditing petty cash the auditor performs tests of details of transactions and balances
- The auditor tests a number of replenishing transactions

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Special Considerations for Cash Balances (4 of 4)

- An entity may use an imprest bank account for payroll and dividends
- Substantive tests typically include: confirming the balance with the bank, reviewing the bank reconciliations, and using the subsequent period's bank statement

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Audit Objectives: Investments (1 of 5)

- Investments in other entities are typically held for one of two reasons:
  - To hold surplus funds or funds earmarked for a future purpose
  - To secure a long-term relationship with the other party

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Audit Objectives: Investments (2 of 5)

- If the investment is held for the purpose of acquiring influence or control over the other entity then the other entity may be classified as subsidiaries, associates, or joint ventures
- These entities are regarded as part of the economic entity

Audit Objectives: Investments (3 of 5)

- Investments can use a variety of forms such as:
  - Equity securities
  - Preference, or
  - Ordinary shares
  - Debt securities
  - Corporate debentures
  - Government bonds
- Investment transactions involve cash receipts such as dividends, interest received on investments, and proceeds upon disposition
- A sample of audit objectives for investments can be found on the next slide(s)

Audit Objectives: Investments (4 of 5)

Transaction and Related Disclosure Objectives	
Occurrence (**OE**)	Investment revenues, gains, and losses resulted from transactions and events that occurred during the period (**OE1**). Disclosed investment transactions pertain to the entity (**OE2**).
Completeness (**C**)	All purchases of investments during the period have been recorded as additions (**C1**). All sales of investments during the period have been recorded as disposals (**C2**).
Accuracy (**AV**)	Investment revenues, gains, and losses are reported at proper amounts (**AV1**).
Cut-off (**CO**)	Investment transactions are recorded in the proper period (**CO1**).
Classification (**D**)	Investment transactions are recorded in the correct accounts (**D1**).
Presentation (**D**)	Investment transactions are appropriately aggregated or disaggregated, clearly described, and the related disclosures are relevant and understandable. (**D2**)

Selected specific audit objectives for investments

Audit Objectives: Investments (5 of 5)

Account Balance and Related Disclosure Objectives	
Existence (**OE**)	Recorded investment balances represent investments that exist at the end of the reporting period (**OE3**).
Rights and obligations (**RO**)	All recorded investments are owned by the reporting entity (**RO1**).
Completeness (**C**)	The income statement includes the effects of all investment transactions and events during the period (**C3**). All required disclosures are made concerning (1) related party investments, (2) the bases for valuing investments, and (3) the pledging of investments as collateral (**C4**).
Accuracy, valuation and allocation (**AV**)	Recorded cash balances are realizable at the amounts stated on the balance sheet and agree with supporting schedules (**AV2**). Investments are disclosed accurately and at appropriate amounts (**AV3**).
Classification (**D**)	Investment balances are properly classified in the financial statements (**D3**).
Presentation (**D**)	Investment accounts are appropriately aggregated or disaggregated, clearly described, and the related disclosures are relevant and understandable. (**D4**)

Selected specific audit objectives for investments

Control Environment (1 of 2)

- An understanding of several control environment factors is relevant to the audit of the investments
- The authority and responsibility for investment transactions should be that of a company officer such as the treasurer

Control Environment (2 of 2)

- The information system must include a provision for capturing the data required for each method of accounting for the various categories of investment
- Internal auditors and the audit committee of the board of directors should closely monitor the effectiveness of controls over investing activities

Functions and Related Controls (1 of 7)

- Purchases and sales should be made in accordance with management’s authorizations
- An investment subsidiary ledger or investment register is used in an entity that has substantial investments

Functions and Related Controls (2 of 7)

- This ledger records details of acquisitions, disposals, interest, dividends, and market values
- Dividend and interest cheques and transfers must be promptly deposited intact, and the completeness of recorded investment income must be independently verified

Functions and Related Controls (3 of 7)

- Transactions should be recorded on the basis of appropriate supporting documentation, and the duties of recording of transactions and custody of the securities should be segregated
- Securities should be stored in safes or vaults, with access restricted to authorized personnel
- Relevant documents should be independently compared with recorded balances

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Functions and Related Controls (4 of 7)

- Changes in value and in circumstances relating to the appropriate classification of investments should be analysed periodically
- Management should undertake performance reviews to detect poor investment performance and/or incorrect reporting
- Periodically the classification of individual investments should be reviewed

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Functions and Related Controls (5 of 7)

- Audit risk - where the investment is non-strategic or there is no significant influence ensuring the market value has been properly valued
- This is more difficult if there is not an active market
- Unlisted companies present a higher level of judgment required to determine the value, and a higher level of inherent risk

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Functions and Related Controls (6 of 7)

- There are also judgments associated with assessing significant influence and control
- Sometimes a company may be reluctant to adopt a certain treatment because of the effect on their financial statements
- Due to the complexity of accounting for some investments, there is a heightened risk of fraud
- Another risk from investments has to do with related party transactions and their disclosures - see IAS 24

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Functions and Related Controls (7 of 7)

- *For most entities, the volume of investing transactions is quite low and thus, it is more efficient to use the substantive approach in the audit of investment balances*

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Substantive Procedures for Investments

- Typically investment transactions are infrequent, but individual transactions are substantial amounts
- Income statement account balances relating to investments are usually verified at the same time

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Auditing Consolidated Financial Statements (1 of 3)

- Where a company controls another company, consolidated financial statements must be prepared
- The economic entity consists of both the parent company and the controlled entities and the auditor is required to report on the consolidated statements

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Auditing Consolidated Financial Statements (2 of 3)

- Auditors need to gather evidence in the following areas:
  - Representations made by those charged with governance as to the existence and ownership of the investment and existence or otherwise of significant influence
  - Appropriateness of carrying amount of investment(s)

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Auditing Consolidated Financial Statements (3 of 3)

- Auditors need to gather evidence in the following areas:
  - Adequacy of financial statement disclosures
  - Appropriateness of equity accounting adjustments such as adjustments for dissimilar accounting policies and elimination of unrealized profits and losses

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Audit Strategy: Consolidated Statements (1 of 9)

- Difficult to generalize about the level of inherent risk as it can vary from very passive and low, to very complex and high
- Typically given the materiality of the amounts involved, the audit approach is a substantive one with little or no reliance on controls
- Detection risk will be inversely related to the inherent risk assessment

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Audit Strategy: Consolidated Statements (2 of 9)

- Additional risk as investments in associates or subsidiaries may be audited by another auditor (see CAS 600 Special Considerations – Audits of a Group Financial Statements)
- A sample of possible substantive tests of consolidated financial statement assertions can be found on the next slide

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Audit Strategy: Consolidated Statements (3 of 9)

	Assertions					
Substantive Procedure	**OE**	**C**	**RO**	**AV**	**CO**	**D**
Identify the reporting entity.	✓	✓	✓			
Verify the financial statements of other group entities.	✓	✓		✓		
Verify the consolidating adjustments.				✓	✓	
Compare the statement presentation with applicable accounting standards.						✓

Possible substantive tests of consolidated financial statement

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Audit Strategy: Consolidated Statements (4 of 9)

- CAS 600 recommends the principal auditor should:
  - Obtain information on the professional competence of the other auditor
  - Advise other auditor of the independence requirements and obtain compliance representation

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Audit Strategy: Consolidated Statements (5 of 9)

- CAS 600 recommends the principal auditor should (continued):
  - Advise the other auditor of the reliance to be placed on his/her work and of any special requirements (for example, intercompany transactions)
  - Advise the other auditor and obtain a compliance representation on applicable accounting and auditing requirements
  - Consider the findings of the other auditor

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Audit Strategy: Consolidated Statements (6 of 9)

- Verifying the consolidating adjustments involves:
  - Acquisitions and disposals
    - Includes testing of entity's fair value measurements and disclosures as well as an evaluation of management assumptions

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Audit Strategy: Consolidated Statements (7 of 9)

- Verifying the consolidating adjustments involves (continued):
  - Elimination of inter-entity balances and transactions
    - Includes ensuring that inter-entity transactions are properly identified and recorded using analysis, review of reconciliations, and their associated eliminations

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Audit Strategy: Consolidated Statements (8 of 9)

- Verifying the consolidating adjustments involves (continued):
  - Standardization of accounting policies
    - Identifying inconsistent policies and verifying the consolidating adjustments
  - Translation of foreign currencies
    - Verifying the exchange rates, check the translations, and ensure accounting treatment conforms – the Effects of Changes in Foreign Exchange Rates (IAS 21)

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Audit Strategy: Consolidated Statements (9 of 9)

- The auditor should ensure that the disclosures in the consolidated financial statements conform to the requirements of applicable accounting standards.

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