CHAPTER 23

AUDIT OF CASH BALANCES

SOCIETY EXPECTS A LOT FROM AUDITORS

Bert Sampson was the controller of Pardoe Manufacturing Company. From 2000 through 2004, Bert paid himself an extra $2 million in "bonuses." He did this by transferring funds from the general account, writing checks to himself from the payroll account, destroying the checks when received from the bank, and making entries directly into the company's computer files to disguise the cash theft. Bert was able to do this because he had almost complete control of the company's accounting process.

Jack Baker of Tramenier and Baker, CPAs, was the partner on the Pardoe audit. Although Baker found a strong control environment at Pardoe and a good budgeting and reporting system, he assessed control risk at maximum because there was limited segregation of duties. Accordingly, Baker used a "substantive" approach to the audit. Baker applied tests of details of balances and analytical procedures to the year-end financial statements. He did no tests of controls or substantive tests of transactions.

Because Sampson had lost all of the $2 million and Pardoe had no fidelity bond insurance, the company sued Tramenier and Baker, CPAs, for the stolen funds, claiming breach of contract. Baker's defense was that he had done the audit in accordance with auditing standards.

The trial revolved around the testimony of two expert witnesses. The witness for the company argued that even though the auditors took a substantive approach to the audit, they should have seen that Sampson had the opportunity to commit the embezzlement, extended their audit, and found it.

The expert for the defense argued that a substantive audit approach is allowed by auditing standards. Sampson manipulated the records so carefully that the substantive procedures of the various payroll accounts did not indicate that the theft had occurred. Because no "red flags" were evident that would have caused the auditors to extend their tests, the audit was clearly satisfactory.

The jury found against the auditors, and Tramenier and Baker, CPAs, was required to pay approximately $2.3 million in damages. When jury members were interviewed about their decision, they indicated that they didn't really understand the technical nature of the arguments made by the expert witnesses, but it was apparent to them that the people who did the audit were extremely bright and competent. Accordingly, the jury members believed that *the auditors certainly had the ability to find the cash theft* and the fact that they didn't meant that they failed to perform up to their potential.

LEARNING OBJECTIVES

After studying this chapter, you should be able to

- **23-1** Show the relationship of cash in the bank to the various transaction cycles.
- **23-2** Identify the major types of cash accounts maintained by business entities.
- **23-3** Design and perform audit tests of the general cash account.
- **23-4** Recognize when to extend audit tests of the general cash account to test further for material fraud.
- **23-5** Design and perform audit tests of the imprest payroll bank account.
- **23-6** Design and perform audit tests of imprest petty cash.

ISBN: 0-536-35831-1

Cash is the only account that is included in several cycles. It is a part of every cycle except inventory and warehousing. The audit of cash balances is the last audit area studied because the evidence accumulated for cash balances depends heavily on the results of the tests in other cycles. For example, if the understanding of internal control and tests of controls and substantive tests of transactions in the acquisition and payment cycle lead the auditor to believe that it is appropriate to reduce assessed control risk to low, the auditor can reduce detailed tests of the ending balance in cash. If, however, the auditor concludes that assessed control risk should be higher, extensive year-end testing may be necessary.

Cash is important primarily because of the potential for fraud but also because there may be errors. The opening vignette provides one example of what can happen if an auditor is not careful in assessing risks in auditing the cash account.

CASH IN THE BANK AND TRANSACTION CYCLES

OBJECTIVE **23-1**

Show the relationship of cash in the bank to the various transaction cycles.

A brief discussion of the relationship between cash in the bank and the other transaction cycles serves a dual function: It clearly shows the importance of the tests of various transaction cycles to the audit of cash, and it aids in further understanding the integration of the different transaction cycles. Figure 23-1 illustrates the relationships of the various transaction cycles, the focal point being the general cash account.

An examination of Figure 23-1 indicates why the general cash account is considered significant in almost all audits, even when the ending balance is immaterial. The amount of cash *flowing* into and out of the cash account is often larger than that for any other account in the financial statements. Furthermore, the susceptibility of cash to defalcation is greater than for other types of assets because most other assets must be converted to cash to make them usable.

In the audit of cash, an important distinction should be made between verifying the client's reconciliation of the balance on the bank statement to the balance in the general ledger and verifying whether recorded cash in the general ledger correctly reflects all cash transactions that took place during the year. It is relatively easy to verify the client's reconciliation of the balance in the bank account to the general ledger, but a significant part of the total audit of a company involves verifying whether cash transactions are properly recorded. For example, each of the following misstatements ultimately results in the improper payment of or the failure to receive cash, but none will normally be discovered as a part of the audit of the bank reconciliation:

- Failure to bill a customer
- Billing a customer at a lower price than called for by company policy
- A defalcation of cash by interception of cash receipts from customers before they are recorded, with the account charged off as a bad debt
- Duplicate payment of a vendor's invoice
- Improper payments of officers' personal expenditures
- Payment for raw materials that were not received
- Payment to an employee for more hours than he or she worked
- Payment of interest to a related party for an amount in excess of the going rate

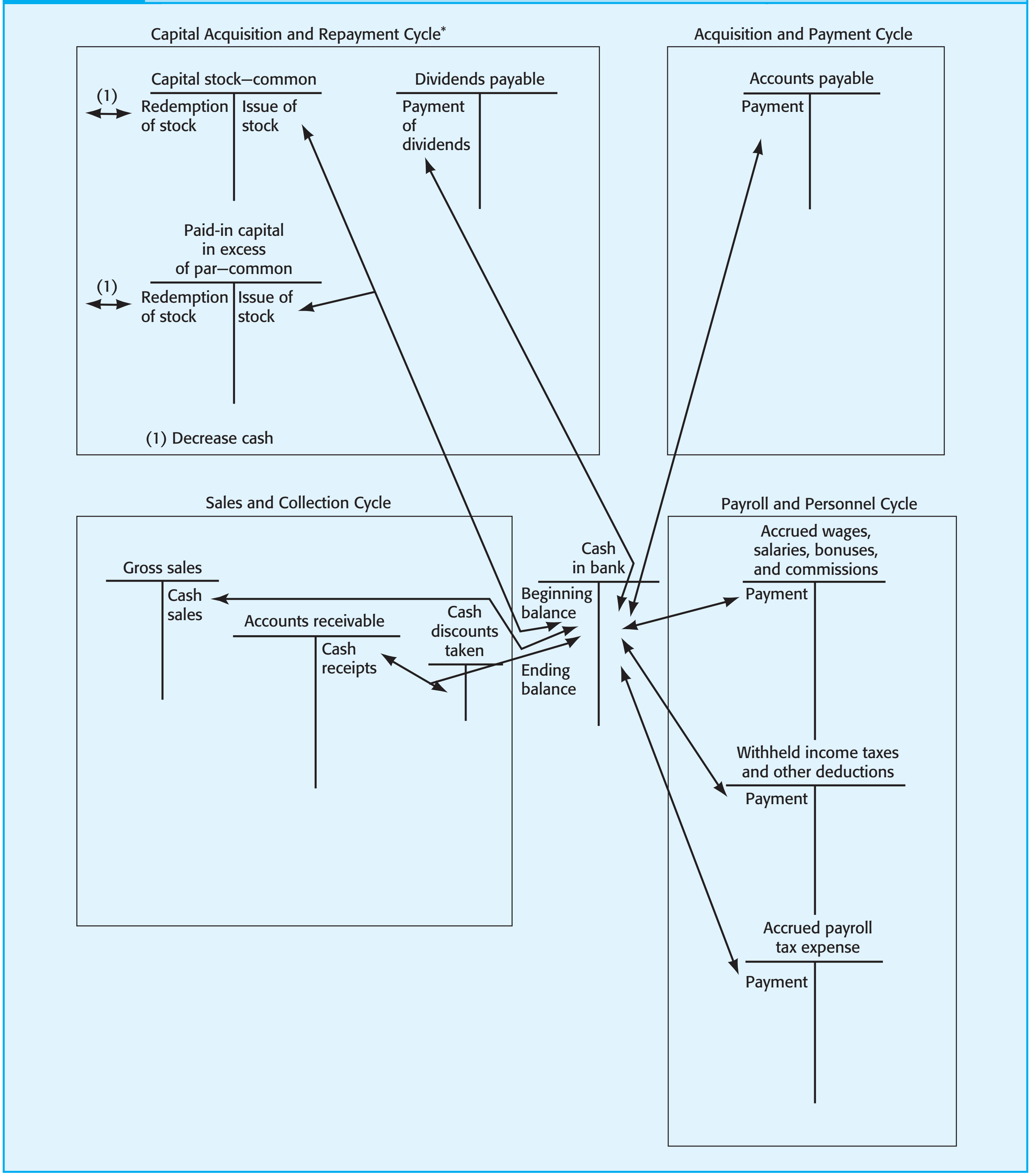
If these misstatements are to be uncovered in the audit, their discovery must come about through the tests of controls and substantive tests of transactions that were discussed in the preceding chapters. The first three misstatements could be discovered as part of the audit of the sales and collection cycle, the next three in the audit of the acquisition and payment cycle, and the last two in the tests of the payroll and personnel cycle and the capital acquisition and repayment cycle, respectively.

Entirely different types of misstatements are normally discovered as a part of the tests of a bank reconciliation. For example,

- Failure to include a check that has not cleared the bank on the outstanding check list, even though it has been recorded in the cash disbursements journal
- Cash received by the client subsequent to the balance sheet date but recorded as cash receipts in the current year

ISBN: 0-536-35831-1

FIGURE 23-1 **Relationships of Cash in the Bank and Transaction Cycles**



*For simplicity, only owners' equity accounts are shown in this figure. For notes payable accounts, see Figure 22-2 on page 668.

- Deposits recorded as cash receipts near the end of the year, deposited in the bank in the same month, and included in the bank reconciliation as a deposit in transit
- Payments on notes payable debited directly to the bank balance by the bank but not entered in the client's records

ISBN: 0-536-35831-1

- Deposits received by the bank on behalf of the company from credit card agencies and other vendors making payments electronically, but not recorded in the client's records

Before we focus on audit tests related to the client's bank reconciliation, it is helpful to discuss the types of cash accounts commonly used by most companies. This is the subject of the next section.

TYPES OF CASH ACCOUNTS

OBJECTIVE **23-2**

Identify the major types of cash accounts maintained by business entities.

It is important to understand the different types of cash accounts because the auditing approach to each varies. When obtaining an understanding of the client's business, the auditor is likely to learn about the various types of cash balances that may exist. For example, when learning about operations at various company locations, the auditor may obtain information about cash accounts maintained at the local and corporate office levels. The following are the major types of cash accounts.

General Cash Account

The **general cash account** is the focal point of cash for most organizations because virtually all cash receipts and disbursements flow through this account. The disbursements for the acquisition and payment cycle are normally paid from this account, and the receipts of cash in the sales and collection cycle are deposited in the account. In addition, the deposits and disbursements for all other cash accounts are normally made through the general account.

Imprest Payroll Account

As a means of improving internal control, many companies establish a separate imprest bank account for such things as making payroll payments to employees or separate cash receipts and disbursements accounts for branch banking. In an **imprest payroll account**, a fixed balance, such as $5,000, is maintained in a separate bank account. Immediately before each pay period, one check or electronic transfer is drawn on the general cash account to deposit the total amount of the net payroll into the payroll account. After all payroll checks have cleared the imprest payroll account, the bank account should have a $5,000 balance. The only deposits into the account are for the weekly and semimonthly payroll, and the only disbursements are paychecks to employees. For companies with many employees, the use of an imprest payroll account can improve internal control and reduce the time needed to reconcile bank accounts.

WWW

Electronic Funds Transfer

A somewhat different type of imprest account consists of one bank account for receipts and a separate one for disbursements. There may be several of these in a company for different divisions. All receipts are deposited in the imprest account, and the total is transferred to the general account periodically. The disbursement account is set up on an *imprest basis*, but in a different manner than an imprest payroll account. A fixed balance is maintained in the imprest account, and the authorized personnel use these funds for disbursements at their own discretion as long as the payments are consistent with company policy. When the cash balance has been depleted, a reimbursement is made to the imprest disbursement account from the general account *after* the expenditures have been approved. The use of such an imprest bank account improves controls over receipts and disbursements. Many companies using imprest bank accounts have online access with their banks that management uses to monitor daily cash balances. When funds need to be transferred into the general account to cover expenditures, approved company personnel can initiate the transfer electronically through the online system.

Branch Bank Account

For a company operating in multiple locations, it is often desirable to have a separate bank balance at each location. **Branch bank accounts** are useful for building public relations in local communities and permitting the centralization of operations at the branch level.

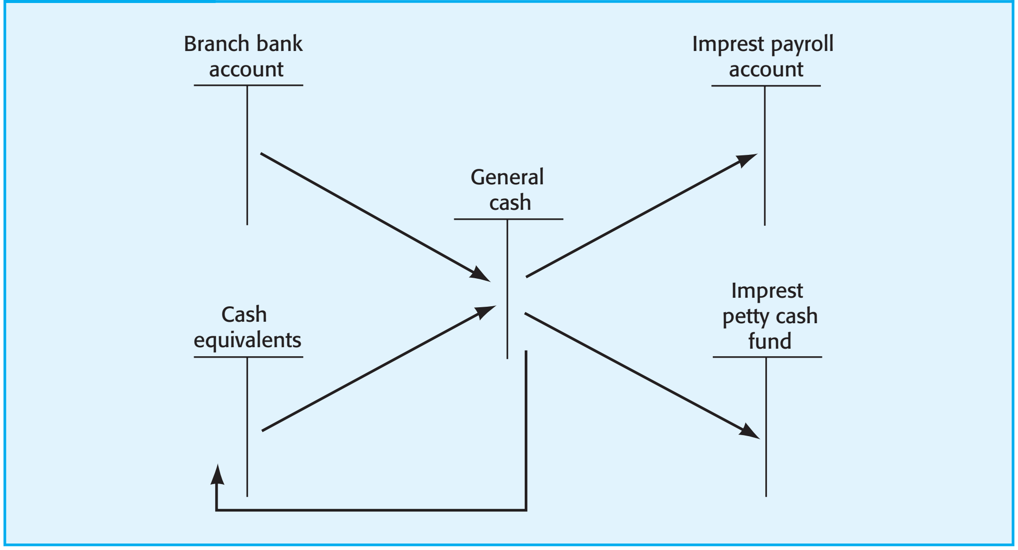
In some companies, the deposits and disbursements for each branch are made to a separate bank account, and the excess cash is periodically electronically transferred to the main office general bank account. The branch account in this instance is much like a general account, but at the branch level.

Imprest Petty Cash Fund

An **imprest petty cash fund** is actually not a bank account, but it is sufficiently similar to cash on deposit to merit inclusion. A petty cash account is often something as simple as a preset amount of cash set aside in a strong box for incidental expenses. It is used for small cash acquisitions that can be paid more conveniently and quickly by cash than by check, or for the

ISBN: 0-536-35831-1

FIGURE 23-2 Relationship of General Cash to Other Cash Accounts



convenience of employees in cashing personal or payroll checks. An imprest cash account is set up on the same basis as an imprest branch bank account, but the expenditures are normally for a much smaller amount. Typical expenses include minor office supplies, stamps, and small contributions to local charities. A petty cash account usually does not exceed a few hundred dollars and may not be reimbursed more than once or twice each month.

Cash Equivalents

Excess cash accumulated during certain parts of the operating cycle that will be needed in the reasonably near future is often invested in short-term, highly liquid **cash equivalents**. Examples include time deposits, certificates of deposit, and money market funds. Cash equivalents, which can be highly material, are included in the financial statements as a part of the cash account only if they are short-term investments that are readily convertible to known amounts of cash within a short time and there is insignificant risk of a change of value from interest rate changes. Marketable securities and longer-term interest-bearing investments are not cash equivalents.

Figure 23-2 shows the relationship of general cash to the other cash accounts. All cash either originates from or is deposited in general cash. The remainder of this chapter focuses on auditing three types of accounts: the general cash account, imprest payroll bank account, and imprest petty cash. The others are similar to these and need not be discussed.

AUDIT OF THE GENERAL CASH ACCOUNT

OBJECTIVE **23-3**

Design and perform audit tests of the general cash account.

On the trial balance of Hillsburg Hardware Co. on page 141, there is only one cash account. Notice, however, that all cycles, except inventory and warehousing, affect cash in the bank.

In testing the year-end balance in the general cash account, the auditor must accumulate sufficient evidence to evaluate whether cash, as stated on the balance sheet, is fairly stated and properly disclosed in accordance with six of the nine balance-related audit objectives used for all tests of details of balances. Rights to general cash, its classification on the balance sheet, and the realizable value of cash are not a problem.

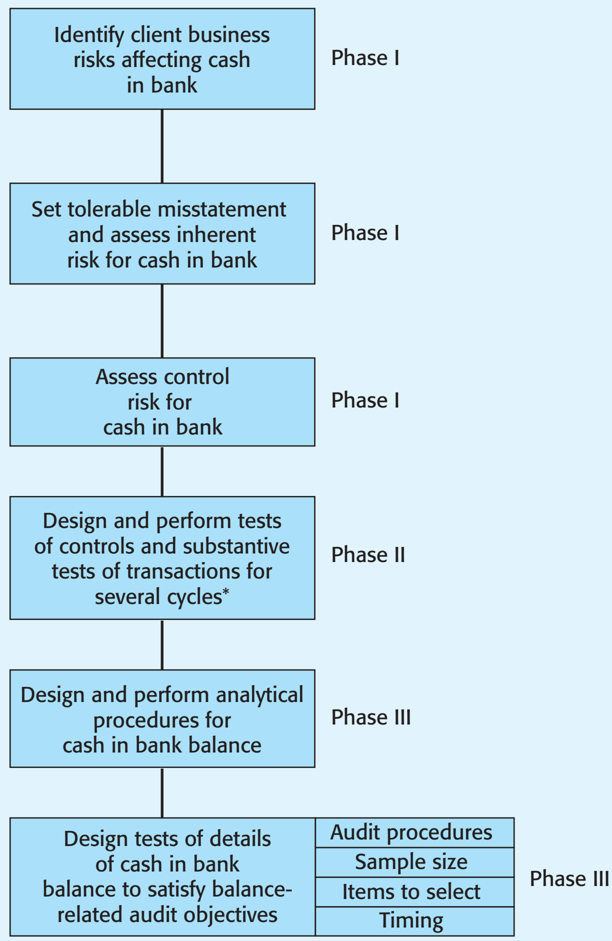
The methodology for auditing year-end cash is essentially the same as that for all other balance sheet accounts. The methodology is shown in Figure 23-3 (p. 690) and then discussed in detail.

Identify Client Business Risks Affecting Cash (Phase I)

Most companies are unlikely to have significant client business risks affecting cash balances. However, client business risk may arise from inappropriate cash management policies or handling of funds held in trust for others. For example, one financial services firm was recently found to have engaged in fraud by intentionally overdrawing cash balances by significant amounts.

ISBN: 0-536-35831-1

FIGURE 23-3 Methodology for Designing Tests of Details of Balances for Cash in the Bank



*Cycles affected include sales and collection, acquisition and payment, payroll and personnel, and capital acquisition and repayment.

Client business risk is more likely to arise from cash equivalents and other types of investments. Many governmental units and other entities suffered losses from repurchases of government securities in the ESM Government Securities case described in Chapter 5. Several financial services firms have suffered large trading losses from the activities of individual traders that were hidden by misstating investment and cash balances. The auditor should understand the risks from the client's investment policies and strategies, as well as management controls that mitigate these risks.

Set Tolerable Misstatement and Assess Inherent Risk (Phase I)

The cash balance is immaterial in most audits, but cash transactions affecting the balance are almost always extremely material. Therefore, there is often potential for material misstatement of cash.

Because cash is more susceptible to theft than other assets, there is high inherent risk for the existence, completeness, and accuracy objectives. These objectives are usually the focus in auditing cash balances. Typically, inherent risk is low for all other objectives.

Assess Control Risk (Phase I)

Internal controls over year-end cash balances in the general account can be divided into two categories: *controls over the transaction cycles* affecting the recording of cash receipts and disbursements and *independent bank reconciliations*.

ISBN: 0-536-35831-1

Controls affecting the recording of cash transactions have been discussed in preceding chapters, but they are essential in deciding control risk for cash. For example, in the acquisition and payment cycle, major controls include adequate segregation of duties between the check signing and accounts payable functions, signing of checks only by a properly authorized person, use of prenumbered checks printed on special paper, adequate control of blank and voided checks, careful review of supporting documentation by the check signer before checks are signed, adequate control over the initiation and approval of wire transfer funds, and adequate internal verification. If controls affecting cash-related transactions are adequate, it is possible to reduce control risk and therefore the audit tests for the year-end bank reconciliation.

A monthly **bank reconciliation** of the general bank account on a timely basis by someone independent of the handling or recording of cash receipts and disbursements is an essential control over the cash balance. If a business defers preparing bank reconciliations for long periods, the value of the control is reduced and may affect the auditor's assessment of control risk for cash. The reconciliation is important to ensure that the books reflect the same cash balance as the actual amount of cash in the bank after considering reconciling items, but even more important, the *independent* reconciliation provides a unique opportunity for an internal verification of cash receipts and disbursements transactions. If the bank statements are received unopened by the reconciler, and physical control is maintained over the statements until the reconciliations are complete, the cancelled checks, duplicate deposit slips, and other documents included in the statement can be examined without concern for the possibility of alterations, deletions, or additions. A careful bank reconciliation by competent client personnel includes the following:

Cash Handling Procedures

- Compare cancelled checks with the cash disbursements records for date, payee, and amount.
- Examine cancelled checks for signature, endorsement, and cancellation.
- Compare deposits in the bank with recorded cash receipts for date, customer, and amount.
- Account for the numerical sequence of checks, and investigate missing ones.
- Reconcile all items causing a difference between the book and bank balance and verify their propriety.
- Reconcile total debits on the bank statement with the totals in the cash disbursements records.
- Reconcile total credits on the bank statement with the totals in the cash receipts records.
- Review month-end interbank transfers for propriety and proper recording.
- Follow up on outstanding checks and stop-payment notices.

Most accounting software packages incorporate a bank reconciliation as a part of end-of-month procedures. Even though the software reduces the clerical efforts in performing the bank reconciliations, it does not eliminate the need for the preparer to do most of the procedures just identified.

Because of the importance of monthly reconciliation of bank accounts, another common control for many companies is to have a responsible employee review the monthly reconciliation as soon as possible after its completion.

Design and Perform Tests of Controls and Substantive Tests of Transactions (Phase II)

Because the cash balance is affected by all other cycles except inventory and warehousing, an extremely large number of transactions affect cash. The appropriate tests of controls and substantive tests of transactions have been discussed in detail in several earlier chapters as the audit of each cycle was studied.

Design and Perform Analytical Procedures (Phase III)

In many audits, the year-end bank reconciliation is extensively audited. Using analytical procedures to test the reasonableness of the cash balance is therefore less important than it is for most other audit areas.

It is common for auditors to compare the ending balance on the bank reconciliation, deposits in transit, outstanding checks, and other reconciling items with the prior-year reconciliation. Similarly, auditors normally compare the ending balance in cash with previous months' balances. These analytical procedures may uncover misstatements in cash.

ISBN: 0-536-35831-1

Design Tests of Details of Cash Balance (Phase III)

The starting point for the verification of the balance in the general bank account is to obtain a bank reconciliation from the client for inclusion in the auditor's documentation. Figure 23-4 shows a bank reconciliation after adjustments. Notice that the bottom figure in the audit schedule is the adjusted balance in the general ledger, which is the balance that should appear on the financial statements. The auditor must determine that the client has made adjustments such as those at the bottom of Figure 23-4 if they are material.

The frame of reference for the audit tests is the bank reconciliation. The balance-related audit objectives and common tests of details of balances are shown in Table 23-1 on page 694. As in all other audit areas, the actual audit procedures depend on the materiality and the risks the auditor has identified in other parts of the audit that are related to cash. Also, because of their close relationship in the audit of year-end cash, the existence of recorded cash in the bank, accuracy, and inclusion of existing cash (completeness) are combined. These three objectives are the most important ones for cash and therefore receive the greatest attention.

The following three procedures merit additional discussion because of their importance and complexity.

Receipt of a Bank Confirmation The direct receipt of a confirmation from every bank or other financial institution with which the client does business is typically done but not required by auditing standards for every audit except when there is an unusually large number of inactive accounts. If the bank does not respond to a confirmation request, the auditor should send a second request or ask the client to telephone the bank. As a convenience to auditors as well as to bankers who are requested to fill out bank confirmations, the AICPA has approved the use of a **standard bank confirmation form**. Figure 23-5 on page 695 is an illustration of a completed standard confirmation. As shown in Figure 23-5, it is called a standard form to confirm account balance information with financial institutions. This standard form has been agreed upon by the AICPA and the American Bankers Association.

The importance of bank confirmations in the audit extends beyond the verification of the actual cash balance. It is typical for the bank to confirm loan information and bank balances on the same form. The confirmation in Figure 23-5 includes three outstanding loans. Information on liabilities to the bank for notes, mortgages, or other debt typically includes the amount of the loan, the date of the loan, its due date, interest rate, and the existence of collateral.

Banks are *not responsible* for searching their records for bank balances or loans beyond those included on the form by the CPA firm's client. A sentence near the bottom of the form obligates banks to inform the CPA firm of any loans not included on the confirmation *about which the bank has knowledge*. The effect of this limited responsibility is to require auditors to satisfy themselves about the completeness objective for unrecorded bank balances and loans from the bank in another manner. Similarly, banks are not expected to inform auditors of such things as open lines of credit, compensating balance requirements, or contingent liabilities for guaranteeing the loans of others. If the auditor wants confirmation of this type of information, a separate confirmation addressing the matters of concern should be obtained from the financial institution.

After the bank confirmation has been received, the balance in the bank account confirmed by the bank should be traced to the amount stated on the bank reconciliation. Similarly, all other information on the reconciliation should be traced to the relevant audit schedules. In any case, if the information is not in agreement, an investigation must be made of the difference.

Receipt of a Cutoff Bank Statement A **cutoff bank statement** is a partial-period bank statement and the related cancelled checks, duplicate deposit slips, and other documents included in bank statements, mailed by the bank directly to the CPA firm's office. The purpose of the cutoff bank statement is to verify the reconciling items on the client's year-end bank reconciliation with evidence that is inaccessible to the client. To fulfill this purpose, the auditor requests the client to have the bank send directly to the auditor the statement for 7 to 10 days subsequent to the balance sheet date.

Many auditors verify the subsequent period bank statement if a cutoff statement is not received directly from the bank. The purpose of this verification is to test whether the client's employees have omitted, added, or altered any of the documents accompanying

ISBN: 0-536-35831-1

FIGURE 23-4 Audit Schedule for a Bank Reconciliation

Microsoft Excel - Book2

File Edit View Insert Format Tools Data Window Help Acrobat

	Clawson Industries Bank Reconciliation 12/31/05	Schedule *A-2* Date Prepared by *Client / DED* *1/10/06* Approved by *SW* *1/18/06*

Acct. 101 – General account, First National Bank

Balance per Bank					109713	*X A-2/1*
Add:						
Deposits in transit						
	12/30			10017 ✓		
	12/31			11100 ✓	21117	
Deduct						
Outstanding checks						
	# 7993	12/16		3068 ✗		
	8007	12/16		9763 ✗		
	8012	12/23		11916 ✗		
	8013	12/23		14717 ✗		
	8029	12/28	*A-7*	37998 ✗		
	8038	12/30	*A-7*	10000 ✗	<87462>	
Other reconciling items: Bank error Deposit for another bank customer credited to General account by bank, in error					<15200>	*A-3*
Balance per bank, adjusted					28168 Λ	*T/B*
Balance per books before adjustments					32584	*A-1*
Adjustments:						
Unrecorded bank service charge				216		*A-3*
Nonsufficient funds check returned by bank, not collectible from customer				4200	<4416>	*C-3/1*
Balance per books, adjusted					28168 Λ	*A-1*

X Traced and agreed to bank confirmation.

✓ Traced deposit to the December 2005 cash receipts records and to the January 2006 bank cutoff statement, noting its proper classification as a deposit in transit at 12/31/05

✗ Traced check to December 2005 cash disbursements records and to the January 2006 bank cutoff statement, noting its proper classification as an outstanding check at 12/31/05

T/B Traced to 12/31/05 adjusted trial balance

Λ Footed

ISBN: 0-536-35831-1

TABLE 23-1 Balance-Related Audit Objectives and Tests of Details of Balances for General Cash in the Bank

Balance-Related Audit Objective	Common Tests of Details of Balances Procedures	Comments
Cash in the bank as stated on the reconciliation foots correctly and agrees with the general ledger (detail tie-in).	Foot the outstanding check list and deposits in transit. Prove the bank reconciliation as to additions and subtractions, including all reconciling items. Trace the book balance on the reconciliation to the general ledger.	These tests are done entirely on the bank reconciliation, with no reference to documents or other records except the general ledger.
Cash in the bank as stated on the reconciliation exists (existence). Existing cash in the bank is recorded (completeness). Cash in the bank as stated on the reconciliation is accurate (accuracy).	*(See extended discussion for each of these.)* Receipt and tests of a bank confirmation. Receipt and tests of a cutoff bank statement. Tests of the bank reconciliation. Extended tests of the bank reconciliation. Proof of cash. Tests for kiting.	These are the three most important objectives for cash in the bank. The procedures are combined because of their close interdependence. The last three procedures should be done only when there are internal control weaknesses.
Cash receipts and cash disbursements transactions are recorded in the proper period (cutoff).	*Cash receipts:* Count the cash on hand on the last day of the year and subsequently trace to deposits in transit and the cash receipts journal. Trace deposits in transit to subsequent period bank statement (cutoff bank statement). *Cash disbursements:* Record the last check number used on the last day of the year and subsequently trace to the outstanding checks and the cash disbursements journal. Trace outstanding checks to subsequent period bank statement.	When cash receipts received after year-end are included in the journal, a better cash position than actually exists is shown. It is called "holding open" the cash receipts journal. Holding open the cash disbursements journal reduces accounts payable and usually overstates the current ratio. The first procedure listed for receipts and disbursements cutoff tests requires the auditor's presence on the client's premises at the end of the last day of the year.
Cash in the bank is properly presented and disclosed (presentation and disclosure).	Examine minutes, loan agreements, and obtain confirmation for restrictions on the use of cash and compensating balances. Review financial statements to make sure (a) material savings accounts and certificates of deposit are disclosed separately from cash in the bank, (b) cash restricted to certain uses and compensating balances are adequately disclosed, and (c) bank overdrafts are included as current liabilities.	An example of a restriction on the use of cash is cash deposited with a trustee for the payment of mortgage interest and taxes on the proceeds of a construction mortgage. A compensating balance is the client's agreement with a bank to maintain a specified minimum in its checking account.

the statement. It is obviously a test for intentional misstatements. The auditor performs the verification in the month subsequent to the balance sheet date by (1) footing all the cancelled checks, debit memos, deposits, and credit memos; (2) checking to see that the bank statement balances when the footed totals are used; and (3) reviewing the items included in the footings to make sure that they were cancelled by the bank in the proper period and do not include any erasures or alterations.

Tests of the Bank Reconciliation As stated earlier, a well-prepared independent bank reconciliation is an essential internal control over cash. The reasons for testing the bank reconciliation are to determine whether client personnel have carefully prepared the bank reconciliation and to verify whether the client's recorded bank balance is the same amount as the actual cash in the bank except for deposits in transit, outstanding checks, and other reconciling items. In testing the reconciliation, the auditor can obtain the information for conducting the tests from the cutoff bank statement. Several major procedures are involved:

ISBN: 0-536-35831-1

- Verify that the client's bank reconciliation is mathematically accurate.
- Trace the balance on the bank confirmation and/or the beginning balance on the cutoff statement to the balance per bank on the bank reconciliation; a reconciliation cannot take place until these balances are the same.
- Trace checks written before year-end and included with the cutoff bank statement to the list of outstanding checks on the bank reconciliation and to the cash disbursements journal in the period or periods prior to the balance sheet date. All checks that cleared

FIGURE 23-5 **Standard Confirmation of Financial Institution Account Balance Information**

Clawson Industries
Bank Confirmation
12/31/05

Schedule *A-2/1*		Date
Prepared by *DED*		*1/10/06*
Approved by *SW*		*1/18/06*

STANDARD FORM TO CONFIRM ACCOUNT
BALANCE INFORMATION WITH FINANCIAL INSTITUTIONS

Clawson Industries
CUSTOMER NAME

Financial Institution's Name and Address

[*First National Bank*
200 Oak Street
Midvale, Illinois 40093]

We have provided to our accountants the following information as of the close of business on **December 31, 2005,** 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	ACCOUNT NUMBER	INTEREST RATE	BALANCE*
General account	*19751-974*	*None*	*109,713.11* *A-2*

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

ACCOUNT NO./ DESCRIPTION	BALANCE*	DATE DUE	INTEREST RATE	DATE THROUGH WHICH INTEREST IS PAID	DESCRIPTION OF COLLATERAL
N/A	*50,000.00*	*1/9/06*	*10%*	*N/A*	*General*
N/A	*90,000.00*	*1/9/06*	*10%*	*N/A*	*Security*
N/A	*60,000.00*	*1/23/06*	*11%*	*N/A*	*Agreement*

A.L. Moore
(Customer's Authorized Signature)

January 3, 2006
(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.

Margaret Davis
(Financial Institution Authorized Signature)

January 10, 2006
(Date)

Vice President
(Title)

EXCEPTIONS AND/OR COMMENTS

None

Please return this form directly to our accountants:

Jones and Smith CPAs
2111 First Street
Detroit, Michigan 48711

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

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

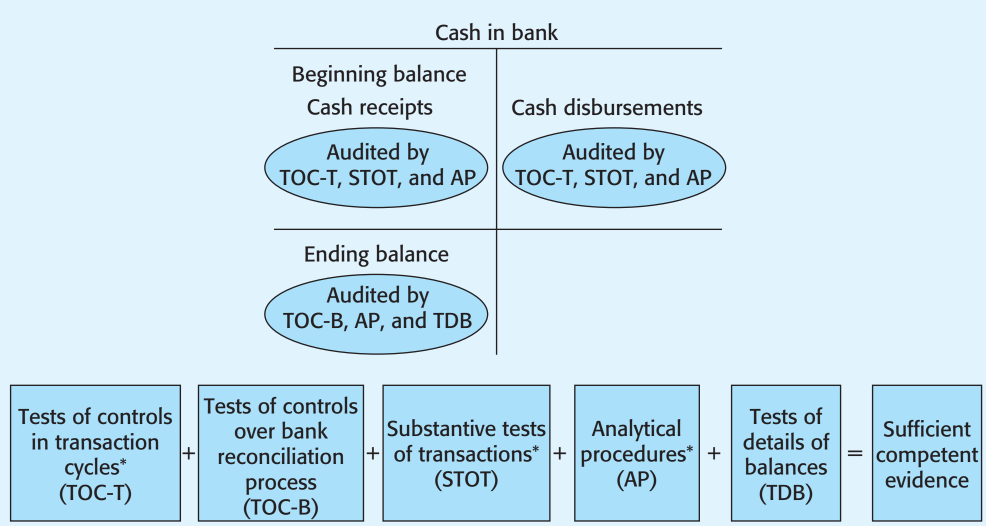
ISBN: 0-536-35831-1

the bank after the balance sheet date and were included in the cash disbursements journal should also be included on the outstanding check list. If a check was included in the cash disbursements journal, it should be included as an outstanding check if it did not clear before the balance sheet date. Similarly, if a check cleared the bank before the balance sheet date, it should not be on the bank reconciliation.

- Investigate all significant checks included on the outstanding check list that have not cleared the bank on the cutoff statement. The first step in the investigation should be to trace the amount of any items not clearing to the cash disbursements journal. The reason for the check not being cashed should be discussed with the client, and if the auditor is concerned about the possibility of fraud, the vendor's accounts payable balance should be confirmed to determine whether the vendor has recognized the receipt of the cash in its records. In addition, the cancelled check should be examined before the last day of the audit if it becomes available.
- Trace deposits in transit to the cutoff bank statement. All cash receipts not deposited in the bank at the end of the year should be traced to the cutoff bank statement to make sure that they were deposited shortly after the beginning of the new year.
- Account for other reconciling items on the bank statement and bank reconciliation. These include such items as bank service charges, bank errors and corrections, and unrecorded transactions debited or credited directly to the bank account by the bank. These reconciling items should be investigated carefully to be sure that they have been treated properly by the client.

Figure 23-6 illustrates how the types of audit tests are used to audit the general cash account. Observe in the figure that tests of controls, substantive tests of transactions, and analytical procedures are done for each transaction cycle involving the cash account.

FIGURE 23-6 **Types of Audit Tests Used for General Cash in the Bank**



*Tests of controls in transaction cycles, substantive tests of transactions, and analytical procedures are done for the four transaction cycles included in Figure 23-1. The primary tests of the ending cash balance are tests of details of balances.

FRAUD-ORIENTED PROCEDURES

OBJECTIVE **23-4**

Recognize when to extend audit tests of the general cash account to test further for material fraud.

A major consideration in the audit of the general cash balance is the possibility of fraud. The auditor must extend the procedures in the audit of year-end cash to determine the possibility of a material fraud when there are inadequate internal controls, especially the improper segregation of duties between the handling of cash and the recording of cash transactions in the accounting records.

ISBN: 0-536-35831-1

In designing audit procedures for uncovering fraud, careful consideration should be given to the nature of the weaknesses in internal control, the type of fraud that is likely to result from the weaknesses, the potential materiality of the fraud, and the audit procedures that are most effective in uncovering the fraud. When auditors are specifically testing for fraud, they should keep in mind that audit procedures other than tests of details of cash balances can also be useful. Examples of procedures that may uncover fraud in the cash receipts area include the confirmation of accounts receivable, tests for lapping, reviewing the general ledger entries in the cash account for unusual items, tracing from customer orders to sales and subsequent cash receipts, and examining approvals and supporting documentation for bad debts and sales returns and allowances. Similar tests can be used for testing for the possibility of fraudulent cash disbursements.

Even with reasonably elaborate fraud-oriented procedures, it is extremely difficult to detect fraud, especially omitted transactions and account balances. If, for example, a company has illegal offshore cash accounts and makes deposits to those accounts from unrecorded sales, it is unlikely that an auditor will uncover the fraud. Nevertheless, auditors are responsible for making a reasonable effort to detect fraud when they have reason to believe it may exist. The following procedures for uncovering fraud that are directly related to year-end cash balances are discussed in this section: extended tests of the bank reconciliation, proofs of cash, and tests of interbank transfers.

Extended Tests of the Bank Reconciliation

When the auditor believes that the year-end bank reconciliation may be intentionally misstated, it is appropriate to perform extended tests of the year-end bank reconciliation. The purpose of the extended procedures is to verify whether all transactions included in the journals for the last month of the year were correctly included in or excluded from the bank reconciliation and to verify whether all items in the bank reconciliation were correctly included. Let us assume that there are material internal control weaknesses and the client's year-end is December 31. A common approach is to start with the bank reconciliation for November and compare all reconciling items with cancelled checks and other documents in the December bank statement. In addition, all remaining cancelled checks and deposit slips in the December bank statement should be compared with the December cash disbursements and receipts journals. All uncleared items in the November bank reconciliation and the December cash disbursements and receipts journals should be included in the client's December 31 bank reconciliation. Similarly, all reconciling items in the December 31 bank reconciliation should be items from the November bank reconciliation and December's journals that have not yet cleared the bank.

In addition to the tests just described, the auditor must carry out procedures subsequent to the end of the year with the use of the bank cutoff statement. These tests would be performed in the same manner as previously discussed.

CASH FRAUD SCHEMES

The Association of Certified Fraud Examiners (ACFE) 2002 study of 663 occupational frauds found that while the largest losses tended to result from fraudulent financial reporting, asset misappropriations were by far the most common type of fraud scheme, accounting for over 80% of the cases studied. As expected, the asset most likely to be targeted by dishonest employees is cash. Cash fraud schemes can generally be divided into three categories:

1. **Fraudulent disbursements**—Examples include the submission of false invoices, false timecards, or false reimbursement requests and the recording of false entries in the cash disbursements journal to conceal the theft of cash.
2. **Skimming**—Cash is stolen from an organization before it is recorded in the accounting records.
3. **Cash larceny**—Cash is stolen from an organization after it has been recorded in the accounting records.

Among these three categories, fraudulent disbursements were reported most frequently in the ACFE study and had the highest median loss, with an average cost of $100,000 per occurence.

Source: 2002 *Report to the Nation: Occupational Fraud and Abuse,* Association of Certified Fraud Examiners, 2002, Austin, Texas.

ISBN: 0-536-35831-1

Proof of Cash

Auditors sometimes prepare a proof of cash when the client has material internal control weaknesses in cash. The auditor uses a proof of cash to determine whether the following were done:

- All recorded cash receipts were deposited.
- All deposits in the bank were recorded in the accounting records.
- All recorded cash disbursements were paid by the bank.
- All amounts that were paid by the bank were recorded.

A **proof of cash** includes the following:

- A reconciliation of the balance on the bank statement with the general ledger balance at the beginning of the proof-of-cash period
- A reconciliation of cash receipts deposited per the bank with the cash receipts journal for a given period
- A reconciliation of cancelled checks clearing the bank with the cash disbursements journal for a given period
- A reconciliation of the balance on the bank statement with the general ledger balance at the end of the proof-of-cash period

A proof of cash of this nature is commonly called a four-column proof of cash—one column is used for each of the types of information just listed. A proof of cash can be performed for one or more interim months, the entire year, or the last month of the year. Figure 23-7 shows a four-column proof of cash for an interim month.

The concern in an interim-month proof of cash is not with adjusting account balances, but rather with reconciling the amounts per books and bank.

When a proof of cash is done, the auditor is combining substantive tests of transactions and tests of details of balances. For example, a proof of cash receipts is a test of recorded transactions, whereas a bank reconciliation is a test of the balance in cash at a point in time. A proof of cash is an excellent method of comparing recorded cash receipts and disbursements with the bank account and with the bank reconciliation. However, the auditor must recognize that a proof of cash disbursements is not effective for discovering checks written for an improper amount, fraudulent checks, or other misstatements in which the dollar amount appearing on the cash disbursements records is incorrect. Similarly, proof-of-cash receipts is not useful for uncovering the theft of cash receipts or the recording and deposit of an improper amount of cash.

Tests of Interbank Transfers

Embezzlers occasionally cover a defalcation of cash by a practice known as **kiting**: transferring money from one bank to another and improperly recording the transaction. Near the balance sheet date, a check is drawn on one bank account and immediately deposited in a second account for credit before the end of the accounting period. In making this transfer, the embezzler is careful to make sure that the check is deposited at a late enough date so that it does not clear the first bank until after the end of the period. If the interbank transfer is not recorded until after the balance sheet date, the amount of the transfer is recorded as an asset in both banks. Although there are other ways of perpetrating this fraud, each involves the device of increasing the bank balance to cover a shortage by the use of interbank transfers.

A useful approach to test for kiting, as well as for unintentional errors in recording interbank transfers, is to list all interbank transfers made a few days before and after the balance sheet date and to trace each to the accounting records for proper recording. An example of an interbank transfer schedule is included in Figure 23-8 (p. 700). The schedule shows that four interbank transfers were made shortly before and after the balance sheet date.

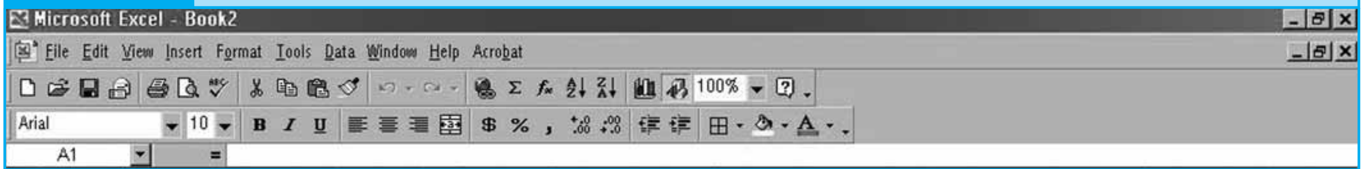
There are several things that should be audited on the interbank transfer schedule.

- *The accuracy of the information on the interbank transfer schedule should be verified*. The auditor should compare the disbursement and receipt information on the schedule to the cash disbursements and cash receipts records to make sure that it is accurate. Similarly, the dates on the schedule for transfers that were received and disbursed

ISBN: 0-536-35831-1

should be compared with the bank statement. Finally, cash disbursements and receipts records should be examined to make sure that all transfers a few days before and after the balance sheet date have been included on the schedule. The tick mark explanations on the schedule in Figure 23-8 indicate that these steps have been taken.

FIGURE 23-7 Interim Proof of Cash



Clawson Industries
Interim Proof of Cash
6/30/05

Schedule	A-5	Date
Prepared by	JG	7/15/05
Approved by	RP	7/17/05

Acct. 101 – General account, First National Bank

		5/31/05	Receipts	Disbursements	6/30/05
Balance per Bank	1	121782.12	627895.20	631111.96	118565.36
Deposits in transit					
5/31	2	21720.00	<21720.00>		
6/30	2		16592.36		16592.36
Outstanding checks					
5/31	3	<36396.50>		<36396.50>	
6/30	3			14800.10	<14800.10>
NSF checks	4		<4560.00>	<4560.00>	
To allow for effect of a cash disbursement recorded as a credit item in cash receipts journal			<8500.00>	<8500.00>	
Balance per bank, adjusted		107105.62	609707.56	596455.56	120357.62
Balance per books, unadjusted		107105.62	609707.56	597957.04	118856.14
Bank debit memos	5			120.00	<120.00>
Payroll checks erroneously entered in General Disbursements Journal	6			<1621.48>	1621.48
Balance per books, adjusted		107105.62	609707.56	596455.56	120357.62

1 Per 6/30/05 bank statement.
2 Detailed listing filed below; traced to subsequent bank statements.
3 Outstanding-check list filed below; examined cancelled checks.
4 Detailed listing filed below; all NSF items were redeposited in June and had all cleared as of 6/30/05.
5 Safety deposit rentals; traced to recording via journal entry.
Requested list of contents of safety deposit boxes.
6 Traced to journal entry correcting error.

ISBN: 0-536-35831-1

FIGURE 23-8 **Interbank Transfer Schedule**

Microsoft Excel - Book2

Clawson Industries
Schedule of Interbank Transfers
December 31, 2005

Schedule *A-7*
Prepared by *Client / DED 1/10/06*
Approved by *SW 1/18/06*

	Disbursements				Receipts		
Check No. (1)	Bank (2)	Amount (3)	Date Recorded in Books (4)	Date Paid by Bank (5)	Bank (6)	Date Recorded in Books (7)	Date Received by Bank (8)
#8018	First National - general	$20,642✓	12-26-05 ⊗	12-28-05 □	Federal Charter - payroll	12-28-05 ⊘	12-29-05 □ ∅
#8029	First National - general	$37,998✓ *A-2*	12-28-05 ✗	01-02-06 □	Federal Charter - savings	12-29-05 ⊘	12-29-05 □ ∅
#8038	First National - general	$10,000✓ *A-2*	12-30-05 ✗	01-04-06 □	Federal Charter - savings	12-30-05 ⊘	01-03-06 □ ⓦ
#8045	First National - general	$21,014✓	01-02-06 ⊗	01-04-06 □	Federal Charter - payroll	01-03-06 ⊘	01-04-06 □ ∅

✓ Traced to cash disbursements records.
⊘ Traced to cash receipts records.
✗ Check included as outstanding on bank reconciliation.
⊗ Check not included as outstanding on bank reconciliation.
ⓦ Receipt included as a deposit in transit.
□ Traced to bank statement.
∅ Receipt not included as a deposit in transit.

Note: Examined cash disbursements and cash receipts records for checks to and deposits from bank accounts. None included except those listed above.

- *The interbank transfers must be recorded in both the receiving and disbursing banks.* If, for example, there was a $10,000 transfer from Bank A to Bank B but only the disbursement was recorded, this is evidence of an attempt to conceal a cash theft.
- *The date of the recording of the disbursements and receipts for each transfer must be in the same fiscal year*. In Figure 23-8, the dates in the two "date recorded in books" columns [columns (4) and (7)] are in the same period for each transfer; therefore, they are correct. If a cash receipt was recorded in the current fiscal year and the disbursement in the subsequent fiscal year, it may be an attempt to cover a cash shortage.
- *Disbursements on the interbank transfer schedule should be correctly included in or excluded from year-end bank reconciliations as outstanding checks*. In Figure 23-8, the 12-31-05 bank reconciliation for the general cash account should include outstanding checks for the second and third transfers but not the other two. [Compare the dates in columns (4) and (5).] Understating outstanding checks on the bank reconciliation indicates the possibility of kiting.
- *Receipts on the interbank transfer schedule should be correctly included in or excluded from year-end bank reconciliations as deposits in transit*. In Figure 23-8, the 12-31-05 bank reconciliations for the savings and payroll accounts should indicate a deposit in transit for the third transfer but not for the other three. (Compare the dates for each transfer in the last two columns.) Overstating deposits in transit on the bank reconciliation indicates the possibility of kiting.

Even though audit tests of interbank transfers are usually fraud oriented, they are often performed on audits in which there are numerous bank transfers, regardless of internal controls. When there are numerous interbank transfers, it is difficult to be sure that each is

ELECTRONIC TRANSFER OF CASH

Many organizations use electronic transfer when they are transferring cash among banks, collecting from customers, and paying vendors. Companies engaging in e-commerce sales activities may receive electronic funds from credit card agencies submitting payments on behalf of customers. Under these systems, cash is transferred instantly. For example, when Company A collects from Credit Card Agency X, the cash is instantly transferred from Credit Card Agency X's bank account to Company A's. There is no check.

Electronic transfers have the potential to improve internal controls in that no cash is handled by employees. However, there is also potential risk of cash thefts through inappropriate cash transfers. It is essential that excellent internal controls be in place for electronic transfers.

correctly handled unless a schedule of transfers near the end of the year is prepared and each transfer is traced to the accounting records and bank statements. In addition to the possibility of kiting, inaccurate handling of transfers could result in a misclassification between cash and accounts payable. The materiality of transfers and the relative ease of performing the tests make many auditors believe they should always be performed.

AUDIT OF THE IMPREST PAYROLL BANK ACCOUNT

OBJECTIVE **23-5**

Design and perform audit tests of the imprest payroll bank account.

Tests of the payroll bank reconciliation should take only a few minutes if there is an imprest payroll account and an independent reconciliation of the bank account such as that described for the general account. Typically, the only reconciling items are outstanding checks, and for most audits, the great majority clear shortly after the checks are issued. In testing the payroll bank account balances, it is necessary to obtain a bank reconciliation, a bank confirmation, and a cutoff bank statement. The reconciliation procedures are performed in the same manner as those described for general cash except that tests of the outstanding checks are normally limited to a reasonableness test. Naturally, extended procedures are necessary if the controls are inadequate or if the bank account does not reconcile with the general ledger imprest cash balance.

Keep in mind that these procedures pertain only to the imprest bank account, not to the overall payroll cycle. Auditing the payroll cycle was discussed in detail in an earlier chapter.

AUDIT OF IMPREST PETTY CASH

OBJECTIVE **23-6**

Design and perform audit tests of imprest petty cash.

Petty cash is a unique account because it is often immaterial in amount, yet it is verified on many audits. The account is verified primarily because of the potential for defalcation and the client's expectation of auditor consideration even when the amount is immaterial.

Internal Controls Over Petty Cash

The most important internal control for petty cash is the use of an imprest fund that is the responsibility of *one individual*. In addition, petty cash funds should not be mingled with other receipts, and the fund should be kept separate from all other activities. There should also be limits on the amount of any expenditure from petty cash, as well as on the total amount of the fund. The type of expenditure that can be made from petty cash transactions should be well defined by company policy.

When a disbursement is made from petty cash, adequate internal controls require a responsible official's approval on a prenumbered petty cash form. The total of the actual cash and checks in the fund plus the total unreimbursed petty cash forms that represent actual expenditures should equal the total amount of the petty cash fund stated in the general ledger. Periodically, surprise counts and a reconciliation of the petty cash fund should be made by the internal auditor or other responsible official.

When the petty cash balance runs low, a check payable to the petty cash custodian should be written on the general cash account for the reimbursement of petty cash. The check should be for the exact amount of the prenumbered vouchers that are submitted as evidence of actual expenditures. These vouchers should be verified by the accounts payable clerk and cancelled to prevent their reuse.

ISBN: 0-536-35831-1

Audit Tests for Petty Cash

The emphasis in verifying petty cash should be on testing controls over petty cash transactions rather than the ending balance in the account. Even if the amount of the petty cash fund is small, there is potential for numerous improper transactions if the fund is frequently reimbursed.

An important part of testing petty cash is first to determine the client's procedures for handling the fund by discussing internal controls with the custodian and examining the documentation of a few transactions. As a part of obtaining an understanding of internal control, it is necessary to identify internal controls and weaknesses. Even though most petty cash systems are not complex, it is often desirable to use a flowchart and an internal control questionnaire, primarily for documentation in subsequent audits.

Tests of controls and substantive tests of transactions depend on the number and size of the petty cash reimbursements and the auditor's assessed control risk. When control risk is assessed as low and there are few reimbursement payments during the year, it is common for auditors not to test any further, for reasons of immateriality. When the auditor decides to test petty cash, the two most common procedures are to count the petty cash balance and to carry out detailed tests of one or two reimbursement transactions. In such a case, the primary procedures should include footing the petty cash vouchers supporting the amount of the reimbursement, accounting for a sequence of petty cash vouchers, examining the petty cash vouchers for authorization and cancellation, and examining the attached documentation for reasonableness. Typical supporting documentation includes cash register tapes, invoices, and receipts.

Petty cash tests can ordinarily be performed at any time during the year, but as a matter of convenience, they are typically done on an interim date. If the balance in the petty cash fund is considered material, which is rarely the case, it should be counted at the end of the year. Unreimbursed expenditures should be examined as a part of the count to determine whether the amount of unrecorded expenses is material.

SUMMARY

We have seen in this chapter that transactions in most cycles affect the cash account. Because of the relationship between transactions in several cycles and the ending cash account balance, the auditor typically waits to audit the ending cash balance until the results of tests of controls and substantive tests of transactions for all cycles are completed and analyzed. As shown in this chapter, tests of the cash balance normally include tests of the bank reconciliations of key cash accounts, such as the general cash account, imprest payroll account, and imprest petty cash fund. If the auditor assesses a high likelihood of fraud in cash, additional tests may also be performed, such as extended bank reconciliation procedures, a proof of cash, or tests of interbank transfers.

ESSENTIAL TERMS

Bank reconciliation—the monthly reconciliation, usually prepared by client personnel, of the differences between the cash balance recorded in the general ledger and the amount in the bank account

Branch bank accounts—separate bank accounts maintained at local banks by branches of a company

Cash equivalents—excess cash invested in short-term, highly liquid investments such as time deposits, certificates of deposit, and money market funds

Cutoff bank statement—a partial-period bank statement and the related cancelled checks, duplicate deposit slips, and other documents included in bank statements, mailed by the bank directly to the auditor; the auditor uses it to verify reconciling items on the client's year-end bank reconciliation

General cash account—the primary bank account for most organizations; virtually all cash receipts and disbursements flow through this account at some time

Imprest payroll account—a bank account to which the exact amount of payroll for the pay period is transferred by check or electronic transfer from the employer's general cash account

Imprest petty cash fund—a fund of cash maintained within the company for small cash acquisitions or to cash employees' checks; the fund's fixed balance is comparatively small and is periodically reimbursed

Kiting—the transfer of money from one bank to another and improperly recording the transfer so that the amount is recorded as an asset in both accounts; this practice is used by embezzlers to cover a defalcation of cash

ISBN: 0-536-35831-1

Proof of cash—a four-column audit schedule prepared by the auditor to reconcile the bank's record of the client's beginning balance, cash deposits, cleared checks, and ending balance for the period with the client's records

Standard bank confirmation form—a form approved by the AICPA and American Bankers Association through which the bank responds to the auditor about bank balance and loan information provided on the confirmation

REVIEW QUESTIONS

23-1 (Objectives 23-1, 23-2) Explain the relationships among the initial assessed control risk, tests of controls and substantive tests of transactions for cash receipts, and the tests of details of cash balances.

23-2 (Objectives 23-1, 23-2) Explain the relationships among the initial assessed control risk, tests of controls and substantive tests of transactions for cash disbursements, and the tests of details of cash balances. Give one example in which the conclusions reached about internal controls in cash disbursements would affect the tests of cash balances.

23-3 (Objective 23-3) Why is the monthly reconciliation of bank accounts by an independent person an important internal control over cash balances? Which individuals would generally not be considered independent for this responsibility?

23-4 (Objective 23-3) Evaluate the effectiveness and state the shortcomings of the preparation of a bank reconciliation by the controller in the manner described in the following statement: "When I reconcile the bank account, the first thing I do is to sort the checks in numerical order and find which numbers are missing. Next I determine the amount of the uncleared checks by referring to the cash disbursements journal. If the bank account reconciles at that point, I am all finished with the reconciliation. If it does not, I search for deposits in transit, checks from the beginning outstanding check list that still have not cleared, other reconciling items, and bank errors until it reconciles. In most instances, I can do the reconciliation in 20 minutes."

23-5 (Objective 23-3) How do bank confirmations differ from positive confirmations of accounts receivable? Distinguish between them in terms of the nature of the information confirmed, the sample size, and the appropriate action when the confirmation is not returned after the second request. Explain the rationale for the differences between these two types of confirmations.

23-6 (Objective 23-3) Evaluate the necessity of following the practice described by an auditor: "In confirming bank accounts I insist upon a response from every bank the client has done business with in the past 2 years, even though the account may be closed at the balance sheet date."

23-7 (Objective 23-3) Describe what is meant by a cutoff bank statement and state its purpose.

23-8 (Objective 23-3) Why are auditors usually less concerned about the client's cash receipts cutoff than the cutoff for sales? Explain the procedure involved in testing for the cutoff for cash receipts.

23-9 (Objective 23-2) What is meant by an imprest bank account for a branch operation? Explain the purpose of using this type of bank account.

23-10 (Objective 23-4) Explain the purpose of a four-column proof of cash. List two types of misstatements it is meant to uncover.

23-11 (Objective 23-3) When the auditor fails to obtain a cutoff bank statement, it is common to verify the entire statement for the month subsequent to the balance sheet date. How is this done and what is its purpose?

23-12 (Objective 23-4) Distinguish between lapping and kiting. Describe audit procedures that can be used to uncover each.

23-13 (Objective 23-5) Assume that a client with excellent internal controls uses an imprest payroll bank account. Explain why the verification of the payroll bank reconciliation ordinarily takes less time than the tests of the general bank account, even if the number of checks exceeds those written on the general account.

23-14 (Objective 23-6) Distinguish between the verification of petty cash reimbursements and the verification of the balance in the fund. Explain how each is done. Which is more important?

23-15 (Objectives 23-3, 23-4) Why is there a greater emphasis on the detection of fraud in tests of details of cash balances than for other balance sheet accounts? Give two specific examples that demonstrate how this emphasis affects the auditor's evidence accumulation in auditing year-end cash.

23-16 (Objective 23-3) Explain why, in verifying bank reconciliations, most auditors emphasize the possibility of a nonexistent deposit in transit being included in the reconciliation and an outstanding check being omitted rather than the omission of a deposit in transit and the inclusion of a nonexistent outstanding check.

ISBN: 0-536-35831-1

23-17 (Objective 23-3) How would a company's bank reconciliation reflect an electronic deposit of cash received by the bank from credit card agencies making payments on behalf of customers purchasing products from the company's online Web site, but not recorded in the company's records?

MULTIPLE CHOICE QUESTIONS FROM CPA EXAMINATIONS

23-18 (Objectives 23-3, 23-4) The following questions deal with auditing year-end cash. Choose the best response.

a. A CPA obtains a January 10 cutoff bank statement for his client directly from the bank. Few of the outstanding checks listed on his client's December 31 bank reconciliation cleared during the cutoff period. A probable cause for this is that the client
   (1) is engaged in kiting.
   (2) is engaged in lapping.
   (3) transmitted the checks to the payees after year-end.
   (4) has overstated its year-end bank balance.

b. The auditor should ordinarily mail confirmation requests to all banks with which the client has conducted any business during the year, regardless of the year-end balance, because
   (1) the confirmation form also seeks information about indebtedness to the bank.
   (2) this procedure will detect kiting activities that would otherwise not be detected.
   (3) the mailing of confirmation forms to all such banks is required by auditing standards.
   (4) this procedure relieves the auditor of any responsibility with respect to nondetection of forged checks.

c. The usefulness of the standard bank confirmation request may be limited because the bank employee who completes the form may
   (1) not believe the bank is obligated to verify confidential information to a third party.
   (2) sign and return the form without inspecting the accuracy of the client's bank reconciliation.
   (3) not have access to the client's bank statement.
   (4) be unaware of all the financial relationships that the bank has with the client.

23-19 (Objective 23-4) The following questions deal with discovering fraud in auditing year-end cash. Choose the best response.

a. Which of the following is one of the better auditing techniques to detect kiting?
   (1) Review composition of authenticated deposit slips.
   (2) Review subsequent bank statements and cancelled checks received directly from the banks.
   (3) Prepare a schedule of bank transfers from the client's books.
   (4) Prepare year-end bank reconciliations.

b. The cashier of Baker Company covered a shortage in his cash working fund with cash obtained on December 31 from a local bank by cashing an unrecorded check drawn on the company's New York bank. The auditor would discover this manipulation by
   (1) preparing independent bank reconciliations as of December 31.
   (2) counting the cash working fund at the close of business on December 31.
   (3) investigating items returned with the bank cutoff statements.
   (4) confirming the December 31 bank balances.

c. A cash shortage may be concealed by transporting funds from one location to another or by converting negotiable assets to cash. Because of this, which of the following is vital?
   (1) Simultaneous bank confirmations.
   (2) Simultaneous bank reconciliations.
   (3) Simultaneous four-column proofs of cash.
   (4) Simultaneous surprise cash counts.

DISCUSSION QUESTIONS AND PROBLEMS

23-20 (Objectives 23-3, 23-4) The following are misstatements that might be found in the client's year-end cash balance (assume that the balance sheet date is June 30):

1. A check was omitted from the outstanding check list on the June 30 bank reconciliation. It cleared the bank July 7.

ISBN: 0-536-35831-1

2. A check was omitted from the outstanding check list on the bank reconciliation. It cleared the bank September 6.
3. Cash receipts collected on accounts receivable from July 1 to July 5 were included as June 29 and 30 cash receipts.
4. A loan from the bank on June 26 was credited directly to the client's bank account. The loan was not entered as of June 30.
5. A check that was dated June 26 and disbursed in June was not recorded in the cash disbursements journal, but it was included as an outstanding check on June 30.
6. A bank transfer recorded in the accounting records on July 1 was included as a deposit in transit on June 30.
7. The outstanding checks on the June 30 bank reconciliation were underfooted by $2,000.

Required

a. Assuming that each of these misstatements was intentional (fraud), state the most likely motivation of the person responsible.

b. What control could be instituted for each fraud to reduce the likelihood of occurrence?

c. List an audit procedure that could be used to discover each fraud.

23-21 (Objectives 23-3, 23-4) The following audit procedures are concerned with tests of details of general cash balances:

1. Compare the bank cancellation date with the date on the cancelled check for checks dated on or shortly before the balance sheet date.
2. Trace deposits in transit on the bank reconciliation to the cutoff bank statement and the current year cash receipts journal.
3. Obtain a standard bank confirmation from each bank with which the client does business.
4. Compare the balance on the bank reconciliation obtained from the client with the bank confirmation.
5. Compare the checks returned along with the cutoff bank statement with the list of outstanding checks on the bank reconciliation.
6. List the check number, payee, and amount of all material checks not returned with the cutoff bank statement.
7. Review minutes of the board of directors meetings, loan agreements, and bank confirmation for interest-bearing deposits, restrictions on the withdrawal of cash, and compensating balance agreements.
8. Prepare a four-column proof of cash.

Required

Explain the objective of each.

23-22 (Objective 23-3) You are auditing general cash for the Pittsburg Supply Company for the fiscal year ended July 31, 2005. The client has not prepared the July 31 bank reconciliation. After a brief discussion with the owner, you agree to prepare the reconciliation, with assistance from one of Pittsburg Supply's clerks. You obtain the following information:

	General Ledger	Bank Statement
Beginning balance 7/1/05	$ 4,611	$ 5,753
Deposits		25,056
Cash receipts journal	25,456	
Checks cleared		(23,615)
Cash disbursements journal	(21,811)	
July bank service charge		(87)
Note paid directly		(6,100)
NSF check		(311)
Ending balance 7/31/05	$ 8,256	$ 696

June 30 Bank Reconciliation

Information in General Ledger and Bank Statement	
Balance per bank	$5,753
Deposits in transit	600
Outstanding checks	1,742
Balance per books	4,611

ISBN: 0-536-35831-1

Additional information obtained is as follows:

1. Checks clearing that were outstanding on June 30 totaled $1,692.
2. Checks clearing that were recorded in the July disbursements journal totaled $20,467.
3. A check for $1,060 cleared the bank but had not been recorded in the cash disbursements journal. It was for an acquisition of inventory. Pittsburg Supply uses the periodic-inventory method.
4. A check for $396 was charged to Pittsburg Supply but had been written on a different company's bank account.
5. Deposits included $600 from June and $24,456 for July.
6. The bank charged Pittsburg Supply's account for a nonsufficient check totaling $311. The credit manager concluded that the customer intentionally closed its account and the owner left the city. The check was turned over to a collection agency.
7. A note for $5,800, plus interest, was paid directly to the bank under an agreement signed 4 months ago. The note payable was recorded at $5,800 on Pittsburg Supply's books.

Required

a. Prepare a bank reconciliation that shows both the unadjusted and adjusted balance per books.

b. Prepare all adjusting entries.

c. What audit procedures would you use to verify each item in the bank reconciliation?

d. What is the cash balance that should appear on the July 31, 2005, financial statements?

23-23 (Objectives 23-3, 23-4) In the audit of the Regional Transport Company, a large branch that maintains its own bank account, cash is periodically transferred to the central account in Cedar Rapids. On the branch account's records, bank transfers are recorded as a debit to the home office clearing account and a credit to the branch bank account. Similarly, the home office account is recorded as a debit to the central bank account and a credit to the branch office clearing account. Gordon Light is the head bookkeeper for both the home office and the branch bank accounts. Because he also reconciles the bank account, the senior auditor, Cindy Marintette, is concerned about the internal control weakness.

As a part of the year-end audit of bank transfers, Marintette asks you to schedule the transfers for the last few days in 2004 and the first few days of 2005. You prepare the following list:

Amount of Transfer	Date Recorded in the Home Office Cash Receipts Journal	Date Recorded in the Branch Office Cash Disbursements Journal	Date Deposited in the Home Office Bank Account	Date Cleared the Branch Bank Account
$12,000	12-27-04	12-29-04	12-26-04	12-27-04
26,000	12-28-04	01-02-05	12-28-04	12-29-04
14,000	01-02-05	12-30-04	12-28-04	12-29-04
11,000	12-26-04	12-26-04	12-28-04	01-03-05
15,000	01-02-05	01-02-05	12-28-04	12-31-04
28,000	01-07-05	01-05-05	12-28-04	01-03-05
37,000	01-04-05	01-06-05	01-03-05	01-05-05

Required

a. In verifying each bank transfer, state the appropriate audit procedures you should perform.

b. Prepare any adjusting entries required in the home office records.

c. Prepare any adjusting entries required in the branch bank records.

d. State how each bank transfer should be included in the December 31, 2004, bank reconciliation for the home office account after your adjustments in part b.

e. State how each bank transfer should be included in the December 31, 2004, bank reconciliation of the branch bank account after your adjustments in part c.

23-24 (Objective 23-3) In connection with an audit you are given the following worksheet:

ISBN: 0-536-35831-1

Bank Reconciliation, December 31, 2005

Balance per ledger December 31, 2005		$17,174.86
Add:		
Cash receipts received on the last day of December and charged to "cash in bank" on books but not deposited		2,662.25
Debit memo for customer's check returned unpaid (check is on hand but no entry has been made on the books)		200.00
Debit memo for bank service charge for December		5.50
		$20,142.61
Deduct:		
Checks drawn but not paid by bank (see detailed list below)	$2,267.75	
Credit memo for proceeds of a note receivable that had been left at the bank for collection but which has not been recorded as collected	400.00	
Checks for an account payable entered on books as $240.90 but drawn and paid by bank as $419.00	178.10	(2,945.85)
Computed balance		17,196.76
Unlocated difference		(200.00)
Balance per bank (checked to confirmation)		$16,996.76

Checks Drawn but Not Paid by Bank

No.	Amount
573	$ 67.27
724	9.90
903	456.67
907	305.50
911	482.75
913	550.00
914	366.76
916	10.00
917	218.90
	$2,267.75

Required

a. Prepare a corrected reconciliation.

b. Prepare journal entries for items that should be adjusted prior to closing the books.*

23-25 (Objective 23-4) You are doing the first-year audit of Sherman School District and have been assigned responsibility for doing a four-column proof of cash for the month of October 2005. You obtain the following information:

1. Balance per books	September 30	$8,106
	October 31	3,850
2. Balance per bank	September 30	5,411
	October 31	6,730
3. Outstanding checks	September 30	916
	October 31	1,278
4. Cash receipts for October	per bank	26,536
	per books	19,711
5. Deposits in transit	September 30	3,611
	October 31	693

6. Interest on a bank loan for the month of October, charged by the bank but not recorded, was $596.

*AICPA adapted.

ISBN: 0-536-35831-1

7. Proceeds on a note of the Jones Company were collected by the bank on October 28 but were not entered on the books:

Principal	$3,300
Interest	307
	$3,607

8. On October 26, a $407 check of the Billings Company was charged to Sherman School District's account by the bank in error.
9. Dishonored checks are not recorded on the books unless they permanently fail to clear the bank. The bank treats them as disbursements when they are dishonored and deposits when they are redeposited. Checks totaling $609 were dishonored in October; $300 was redeposited in October and $309 in November.

Required

a. Prepare a four-column proof of cash for the month ended October 31. It should show both adjusted and unadjusted cash.

b. Prepare all adjusting entries.

CASE

23-26 (Objective 23-4) The following information was obtained in an audit of the cash account of Tuck Company as of December 31, 2005. Assume that the CPA has satisfied himself as to the propriety of the cash book, the bank statements, and the returned checks, except as noted.

1. The bookkeeper's bank reconciliation at November 30, 2005.

Balance per bank statement		$19,400
Add: Deposit in transit		1,100
Total		$20,500
Less: Outstanding checks		
#2540	$140	
#1501	750	
#1503	580	
#1504	800	
#1505	30	(2,300)
Balance per books		$18,200

2. A summary of the bank statement for December 2005.

Balance brought forward	$ 19,400
Deposits	148,700
	168,100
Charges	(132,500)
Balance, December 31, 2005	$ 35,600

3. A summary of the cash book for December 2005 before adjustments.

Balance brought forward	$ 18,200
Receipts	149,690
	167,890
Disbursements	(124,885)
Balance, December 31, 2005	$ 43,005

4. Included with cancelled checks returned with the December bank statement were the checks listed on page 709.
5. The Tuck Company discounted its own 60-day note for $9,000 with the bank on December 1, 2005. The discount rate was 6%. The accountant recorded the proceeds as a cash receipt at the face value of the note.
6. The accountant records customers' dishonored checks as a reduction of cash receipts. When the dishonored checks are redeposited, they are recorded as a regular cash receipt. Two N.S.F. checks for $180 and $220 were returned by the bank during December. Both checks were redeposited and were recorded by the accountant.
7. Cancellations of Tuck Company checks are recorded by a reduction of cash disbursements.
8. December bank charges were $20. In addition, a $10 service charge was made in December for the collection of a foreign draft in November. These charges were not recorded on the books.

ISBN: 0-536-35831-1

9. Check 2540 listed in the November outstanding checks was drawn in 2003. Because the payee cannot be located, the president of Tuck Company agreed to the CPA's suggestion that the check be written back into the accounts by a journal entry.
10. Outstanding checks at December 31, 2005, totaled $4,000, excluding checks 2540 and 1504.
11. The cutoff bank statement disclosed that the bank had recorded a deposit of $2,400 on January 2, 2006. The accountant had recorded this deposit on the books on December 31, 2005, and then mailed the deposit to the bank.

Number	Date of Check	Amount of Check	Comment
1501	November 28, 2005	$ 75	This check was in payment of an invoice for $750 and was recorded in the cash book as $750.
1503	November 28, 2005	$ 580	This check was in payment of an invoice for $580 and was recorded in the cash book as $580.
1523	December 5, 2005	$ 150	Examination of this check revealed that it was unsigned. A discussion with the client disclosed that it had been mailed inadvertently before it was signed. The check was endorsed and deposited by the payee and processed by the bank even though it was a legal nullity. The check was recorded in the cash disbursements journal.
1528	December 12, 2005	$ 800	This check replaced 1504, which was returned by the payee because it was mutilated. Check 1504 was not cancelled on the books.
—	December 19, 2005	$ 200	This was a counter check drawn at the bank by the president of the company as a cash advance for travel expense. The president overlooked informing the bookkeeper about the check.
—	December 20, 2005	$ 300	The drawer of this check was the Tucker Company.
1535	December 20, 2005	$ 350	This check had been labeled N.S.F. and returned to the payee because the bank had erroneously believed that the check was drawn by the Luck Company. Subsequently, the payee was advised to redeposit the check.
1575	January 5, 2006	$10,000	This check was given to the payee on December 30, 2005, as a postdated check with the understanding that it would not be deposited until January 5. The check was not recorded on the books in December.

Required

Prepare a four-column proof of cash of the cash receipts and cash disbursements recorded on the bank statement and on the company's books for the month of December 2005. The reconciliation should agree with the cash figure that will appear in the company's financial statements.*

INTERNET PROBLEM 23-1: ELECTRONIC MONEY

Reference the CW site. The U.S. Treasury Department's Financial Management Service has developed Pay.gov to provide electronic collection methods that facilitate the ability of Federal agencies to conduct transactions online. This problem requires students to access the Pay.gov Web site to answer questions about Pay.gov services.

*AICPA adapted.

ISBN: 0-536-35831-1