How to Audit Cash

2nd Edition

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How to Audit Cash

2nd Edition

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Course Information

Course Title: How to Audit Cash

Learning Objectives:

- Recognize examples of cash equivalents
- Identify a characteristic of cash that can have a significant impact on the contents of the audit plan
- Pinpoint one use of a cutoff bank statement
- Recognize a control over depositing cash
- Determine what might be used to identify an employee who is using a company account for his personal use

Subject Area: Auditing

Prerequisites: None

Program Level: Overview

Program Content: This course clarifies for the auditor every action needed to audit cash. It describes the characteristics of cash from an auditing perspective, and then goes on to describe the activities required to audit a client's cash accounts. The course contains extensive material about cash-related controls, fraud issues, and the construction of a bank reconciliation and a proof of cash.

Advance Preparation: None

Recommended CPE Credit: 1 hour

Course Expiration: Based on standards set by NASBA and the AICPA, this course will expire one year from the date of purchase.

About the Author

Steven Bragg, CPA, has been the chief financial officer or controller of four companies, as well as a consulting manager at Ernst & Young. He received a master's degree in finance from Bentley College, an MBA from Babson College, and a Bachelor's degree in Economics from the University of Maine. He has been a two-time president of the Colorado Mountain Club, and is an avid alpine skier, mountain biker, and certified master diver. Mr. Bragg resides in Centennial, Colorado.

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Auditing Cash

Learning Objectives

- Recognize examples of cash equivalents
- Identify a characteristic of cash that can have a significant impact on the contents of the audit plan
- Pinpoint one use of a cutoff bank statement
- Recognize a control over depositing cash

Introduction

Every business needs to maintain a certain amount of cash to use in settlement of its current liabilities. In addition, some firms sell goods and services primarily in cash, so they may have significant cash balances on hand from cash receipts. These cash balances may be aggregated into a number of bank accounts, including the following:

- **Checking account.** This is the general account into which customer payments flow, and from which payables payments are disbursed.
- **Branch account.** A company may operate a separate bank account for each of its branch locations, which is intended to take in and disburse funds related to local operations.
- **Payroll account.** This account receives funding for each successive payroll, which is drawn down as employees cash their paychecks.
- **Petty cash.** This account is maintained internally (it is not a bank account), and contains a small amount of cash for incidental cash purchases.
- **Savings account.** A client may have a separate bank account that is only used for earning interest on excess funds.

The largest amount of transaction volume usually runs through the checking account. The payroll account usually involves a lesser, though still substantial, number of transactions. The total amount of petty cash held within a business at any given time is likely to be immaterial, though the total amount of expenditures paid for by this means could be material. A client may have no savings account at all, if it instead puts excess cash into marketable securities and other investments.

In this course, we examine the characteristics of cash from an auditing perspective, and then note the auditing activities that can be applied to the cash area, with particular attention to the bank reconciliation, proof of cash, and bank transfer schedule.

Cash Equivalents

When a client's cash balance is stated on its balance sheet, the line is frequently listed as "cash and cash equivalents." A cash equivalent is a highly liquid investment having a maturity of three months or less. It should be at minimal risk of a change in value. Examples of cash equivalents are:

- Certificates of deposit
- Commercial paper
- Marketable securities
- Money market funds
- Short-term government bonds
- Treasury bills

To be classified as a cash equivalent, an item must be unrestricted, so that it is available for immediate use. If an investment cannot be converted to cash on short notice, then it should be not be classified as a cash equivalent.

Auditor Objectives

When developing an audit program for cash, the auditor must consider his objectives in this area. They are as follows:

- To discern the internal controls over cash being used by the client.
- To consider the inherent risks associated with cash.
- To gauge the risk of material misstatement.

Based on these objectives, the auditor must develop an audit program that contains adequate tests of the client's substantive procedures and controls that are targeted at the following:

- **Completeness of records.** Verify that the cash stated in the client's records has been fully recorded.
- **Cutoff.** Prove that the transactions triggering the recordation of cash are recorded in the correct period.

- **Disclosure.** Corroborate that the information about cash in the client's financial statements is properly presented and fully disclosed.
- **Existence.** Affirm the existence of cash and that the related transactions occurred.
- **Rights.** Verify that the client has the legal right to the cash it is recognizing.

There is no need to certify that the valuation of cash is correct, though one could examine whether the valuations of any foreign exchange holdings have been properly presented.

Auditing Characteristics of Cash

There are several general characteristics of cash that can impact the contents of the audit plan. These characteristics are:

- **Liquidity.** An essential problem with cash is that it is highly liquid, so it cannot be traced once it has been stolen. This is a major concern for clients that operate largely on a cash basis, requiring multiple layers of controls to minimize the risk of loss. Given the high risk of loss, auditors tend to focus extra attention on cash.
- **Account flow-through.** A vast number of accounting transactions flow through a client's checking account. Cash receipts from revenue transactions are deposited in it, as are cash outflows related to payments, both to suppliers and employees. This means that the auditor will likely want to examine a client's cash accounts quite closely as part of the substantiation of many elements of its financial statements.

In short, the baseline case for a client's cash accounts indicates a relatively high level of auditing effort, especially when the client's cash controls are weak.

Auditing Activities

In this section, we provide an overview of the auditing activities associated with cash, and follow up with more detail on selected auditing tasks in later sections.

Inherent Risk Assessment

The auditor should use his knowledge of the client to consider inherent risks related to cash. Inherent risk is the probability of loss based on the nature of an organization's business, without any changes to the existing environment. The concept can be applied to the financial statements of an organization, where inherent risk is considered to be the risk of misstatement due to existing transactional errors or fraud. Inherent risk is considered to be more likely under the following circumstances:

- **Judgment.** A high degree of judgment is involved in business transactions, which introduces the risk that an inexperienced person is more likely to make an error.
- **Estimates.** Significant estimates must be included in transactions, which makes it more likely that an estimation error will be made.
- **Complexity.** The transactions in which a business engages are highly complex, and so are more likely to be completed or recorded incorrectly. Transactions are also more likely to be complex when there are a large number of subsidiaries submitting information for inclusion in the financial statements.

There is little need for judgment or estimates when dealing with cash-related transactions. However, there is a possibility of transactional complexity related to cash, especially since many transactions originating in other parts of the business flow through the cash area. Also, there is an increased risk of fraud, due to the highly liquid nature of cash. These two issues increase the level of inherent risk associated with cash.

Material Misstatement Assessment

As noted earlier, one of the objectives of the auditor is to gauge the risk of material misstatement. This assessment is largely based on tests of the client's controls over its cash. Several possible misstatements are as follows:

- **Timing error.** An accountant may record a cash receipt or cash expenditure in the wrong period. This mistake can arise when the accounting staff does not pay attention to the proper cutoff of transactions at the end of a reporting period.
- **Window dressing.** A client may attempt to adjust its ending cash balance upward, in order to make the business look more solvent than is really the case. For example, corporate insiders who have borrowed money from the firm could repay the funds just prior to year-end and then take out loans again immediately thereafter. Or, the accounting staff could have an improper period-end cutoff by continuing to record subsequent cash receipts within the period being audited.

The assessment of inherent risk and material misstatement by the auditor determines the extent of the substantive procedures related to cash.

Substantive Procedures

Substantive procedures are intended to create evidence that an auditor assembles to support the assertion that there are no material misstatements in regard to the completeness, validity, and accuracy of the financial records of a client. Thus, substantive procedures are performed in order to detect whether there are any material misstatements in accounting transactions. Substantive procedures include the following general categories of activity:

- Testing classes of transactions, account balances, and disclosures
- Agreeing the financial statements and accompanying notes to the underlying accounting records
- Examining material journal entries and other adjustments made during the preparation of the financial statements

At a general level, substantive procedures related to testing transactions can include the following:

- Examining documentation indicating that a procedure was performed
- Re-performing a procedure to ensure that the procedure functions as planned
- Inquiring or observing regarding a transaction

For example, the auditor may take a sample of cash receipts and trace them through the cash receipts journal and reductions from accounts receivable, as well as into a deposit slip and bank statement. Similarly, the auditor may take a sample of cash disbursements and trace them back through accounts payable postings, supplier invoices, receiving documentation, and purchase orders.

The following are all considered to be substantive procedures for cash. Many of these items are explained more fully in the following sections of this chapter.

1. **Obtain balance detail.** Obtain cash balance information for each cash account and reconcile these balances back to the general ledger.
2. **Confirm balances.** Send confirmation forms to the financial institutions with which the client does business, asking for verification of account balances.

3. **Reconcile accounts.** Either review bank reconciliations prepared by the client or directly prepare the reconciliations.
4. **Examine cutoff.** Obtain a cutoff bank statement that itemizes transactions subsequent to the balance sheet date, and verify that the client has properly cut off the recordation of cash receipts and cash disbursements.
5. **Count cash.** Verify the amount of cash on hand.
6. **Review bank transfers.** Examine any bank transfers for one week on both sides of the balance sheet date.
7. **Examine related party transactions.** Review any unusually large payments to related parties.
8. **Conduct analytical procedures.** Compare the client's cash totals to its operational information to see if there are any disparities worth discussing.
9. **Review presentation.** Review the client's presentation of information in its financial statements related to cash, including disclosures in the accompanying footnotes.

Obtain Balance Detail

Obtain from the client a listing of all cash accounts. This listing includes the ending balance in each account, as well as the name of the bank at which the account is located and the account number. The auditor traces the stated ending balance to the client's general ledger, while the rest of the information is used to prepare bank confirmations, as described in the next section.

Confirm Balances

A key step in the auditing of cash is to substantiate the existence of a client's cash balances. This is most commonly achieved by confirming the amounts on deposit with the relevant financial institutions. Cash confirmation requests are made using a standard confirmation form, which appears in the following exhibit.

Standard Confirmation Form

CUSTOMER NAME

Financial Institution's Name and Address

[ ]

Fourth National Bank
123 West Main Street
Denver, CO 80202

[ ]

We have provided to our accountants the following information as of the close of business in December 31, 20X2, 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 indicate the following deposit balance(s):

Account Name	Account No.	Interest Rate	Balance*
General Account	1428-39205	None	$114,556.03
Payroll Account	1428-29357	None	$43,006.72

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*	Due Date	Interest Rate	Date Through Which Interest Is Paid	Description Of Collateral
Loan	$251,703	4/30/X5	9.75%	12/31/X1	Fixed Assets
Line of credit	$150,000	12/31/X2	8.00%	12/31/X1	Receivables

______________________________ ____________________

(Customer's Authorized Signature) (Date)

The information presented above by the customer is in agreement with our records. Although we have not conducted a comprehensive, detailed search of our records, no other deposit or loan accounts have come to our attention except as noted below.

______________________________ ____________________
(Financial Institution Authorized Signature) (Date)

____
(Title)

EXCEPTIONS AND/OR COMMENTS

Please return this form directly to our accountants:

[ ]

Emerson & Lake, CPAs
412 Wellesley Way
Aurora, CO 80010

[ ]

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

In the preceding exhibit, we have included account information that would be provided by the client. When this type of confirmation is sent, the bank is being asked to corroborate the information presented to it. In addition, the following text is included in the standard confirmation form:

> …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.

This means that the bank is being asked to describe the existence of any additional accounts or loans, which provides some evidence about whether the client has provided complete records. However, this request is buried in the confirmation instructions, so only a more attentive bank employee would see it and therefore provide the additional information.

Tip: The manual issuance of confirmations and the wait for responses can introduce a serious delay into the conduct of an audit. An alternative is provided by www.confirmation.com, which provides a service for electronic confirmation requests and responses. The client must confirm with the website that they are authorizing the use of electronic confirmations. This approach can result in confirmations being issued, completed by recipients, and returned within one business day.

Confirmations should not be mailed from the client's offices, since this presents the opportunity for the client to intercept the confirmations, make fraudulent responses, and then mail them back to the auditor. Instead, all confirmations should be mailed from an external location, such as the local post office.

Confirmations must be received directly by the auditor – they cannot be routed back through the client, since the client would then have the opportunity to adjust the information in the confirmations, or to create fake confirmation responses.

Reconcile Accounts

The cash balance of a client almost never exactly matches the cash balance reported by its financial institution, because there will be cash in transit, or transactions that have been recorded by one party, but not the other. Accordingly, the client will need to create a bank reconciliation (which is described in the following chapter) as of the balance sheet date. The auditor must verify that this reconciliation has been correctly completed, or may directly create the reconciliation without the participation of the client. The examination of a client-prepared bank reconciliation involves the following activities:

- Compare cancelled checks to the client's cash disbursement records for the date, amount, and payee.
- Compare the bank's deposit records to the client's cash receipt records for date, amount, and customer.
- Investigate all reconciling items, such as bank service charges and bank corrections, tracing them back to their respective sources.
- Investigate checks that have been outstanding for a long period of time.
- Monitor the numerical sequence of checks and investigate any missing check numbers.
- Trace the balances in the reconciliation to the bank statement and client general ledger.
- Verify that the arithmetic in the reconciliation is accurate.

A detailed review of a client-prepared bank reconciliation is essential, since a client employee who has committed fraud can deliberately falsify information on the reconciliation in order to hide the theft of cash.

As part of the process of testing client records, the auditor may choose to complete an account reconciliation that had previously been performed by the client, to verify that the client is properly completing reconciliations.

Examine Cutoff

The client requests that its bank prepare a cutoff bank statement, which is a record of all account activity following the client's year-end. This statement typically covers a period of seven to ten business days. The bank mails this statement directly to the auditor, so that the client does not have an opportunity to alter any of the information on the statement. If the audit will not be conducted for at least a month after the client's year-end, an alternative to the cutoff bank statement is to request the next monthly bank statement instead.

Tip: It can be substantially easier to access cutoff bank statement information directly from the bank's website, if it offers this service to its customers.

The auditor traces the information on the cutoff bank statement to any items listed on the client's bank reconciliation as having been in transit as of the balance sheet date. The specific items being examined will likely be deposits in transit and uncashed checks. All deposits in transit should have been received by the bank by the end of the period encompassed by the cutoff bank statement. However, there may still be checks outstanding past this period, since check recipients can be dilatory in cashing them.

The cutoff bank statement can be used to decide whether a client had cut checks at year-end, but did not mail them to recipients until a later date. This can be done by calculating the number of days between the check date and the payment date recorded by the bank. When there is an unusually long interval, the auditor may decide to have the client record an adjusting entry as of year-end, to debit cash and credit the applicable liability account(s).

The auditor should also verify that all cash receipts up to the balance sheet date are included in the client's records for the audit period, while all cash received after that date is recorded in the following accounting period. One way to do this is to be physically present at the close of business on the balance sheet date, to count cash receipts for that day. By doing so, the client will not be able to insert any additional cash receipts that were received after the balance sheet date. Since auditors are not always able to do this, an alternative (and much more common) procedure is to verify that the final deposit in transit as stated on the client's bank reconciliation appears as a credit on the bank's bank statement on the following business day. If the bank records the receipt on a later business day, it is quite possible that the client has incorrectly recorded subsequent cash receipts as being within the period being audited.

Count Cash

Most clients have a small amount of cash on hand at year-end. This amount is comprised of petty cash funds and perhaps undeposited cash receipts. In many organizations, the amount of cash on hand is decidedly immaterial, and may be zero. However, the nature of some businesses (such as casinos and financial institutions) mandates the presence of significant quantities of cash on the premises. In these latter cases, the auditor may need to conduct a cash count to verify the amount of cash on hand. When doing so, there is a possibility that the designated cash custodian will attempt to cover up a cash shortage by claiming that the auditor took the funds. To avoid this situation, always have the custodian present when counting cash, and have the person sign an acknowledgement that the funds were returned intact to the custodian.

Review Bank Transfers

A client may have several bank accounts, and regularly shifts funds among them. For example, it could move cash from its general checking account to its payroll account in order to have sufficient funds on hand for an upcoming issuance of payroll checks to employees. Or, a business sends cash to one of its retail locations to cover anticipated local expenditures. When checks drawn on one bank are deposited in another bank, there will be a brief period before the checks clear the bank on which they have been drawn. During this interval, the amount of the check will appear in the bank balance for both accounts, which represents an overstatement of the client's actual cash balance. A client may deliberately take advantage of this concept (known as *kiting*) to overstate its period-end cash balances.

Kiting can be detected by preparing a schedule of transfers between a client's bank accounts for a few days before and after the balance sheet date, noting the dates when cash is disbursed from one account and received in another account. A sample bank transfer schedule appears in the following exhibit. Kiting is *not* present when there is a decrease in cash in one account and a corresponding increase in cash in another account in the *same* period. However, kiting *is* present under either of the following circumstances:

- The date when either a disbursement or a receipt is recorded by the bank is for the reporting period prior to when the client records the transaction on its books; or
- The date when a cash disbursement is recorded on the client's books differs from the period in which the corresponding cash receipt is recorded on the client's books.

Sample Bank Transfer Schedule

				Disbursement Date		Receipt Date	
Check #	Amount	From	To	Books	Bank	Books	Bank
1728	$45,000	General	Store 1	12/30	1/2	12/30	12/30
1769	29,000	General	Store 2	1/2	1/3	12/31	12/31
1790	31,000	General	Payroll	1/2	1/3	1/2	12/31

In the preceding transfer schedule, notice how check number 1769 was recorded as a receipt on 12/31 in the Store 2 account, while the corresponding disbursement from the general checking account was not recorded until the following period, thereby inflating the year-end cash balance. Similarly, check number 1790 is recorded by the bank as being received on 12/31, even though the client does not record the receipt until the following year. In the latter case, the cash transfer is likely covering up funds that are missing from the payroll account. These are both examples of kiting.

A bank transfer schedule can also detect an outright theft of cash. In this case, there is a recorded outbound transfer from one bank account, but no inbound transfer at a receiving bank account. Instead, someone has intercepted the transferred funds.

Kiting has become more difficult to enact, because most checks are now settled within one or two business days between banks. Consequently, the risk of cash overstatement due to kiting has declined over time.

The preceding discussion makes it clear that a key objective of bank transfer schedules is to detect fraud. However, they are also useful in any situations in which a client has a large number of bank transfers clustered around the year-end period. In these situations, there is a heightened risk of misclassification, which can be spotted with the bank transfer schedule.

Conduct Analytical Procedures

Analytical procedures involve comparisons of different sets of financial and operational information, to see if historical relationships are continuing forward into the period under review. In most cases, these relationships should remain consistent over time. If not, it can imply that the financial records are incorrect, possibly due to errors or fraudulent reporting activity. The following analytical procedures can be applied to cash:

- Compare the ending cash balance in each account to the balance in the prior year
- Compare the aggregate amount of deposits in transit to the same amount in the prior year
- Compare the aggregate amount of outstanding checks to the same amount in the prior year
- Compare the ending cash balance to the ending cash balances in prior months of the same year

The last of these items (monitoring a trend line of ending cash balances) may be the most valuable, since it can spotlight the presence of window dressing, where the client takes deliberate steps to improve its year-end cash balance.

When the results of these procedures are materially different from expectations, the auditor should discuss them with the client's management. A certain amount of skepticism is needed when having this discussion, since management may not want to spend the time to delve into a detailed explanation, or may be hiding fraudulent behavior. Management responses should be documented, and could be valuable as a baseline when conducting the same analysis in the following year.

Review Presentation

The cash line item appearing in the balance sheet should only include cash that is available for immediate use. If cash has been restricted in any way, it should not appear in this line item. For example, a client may be subject to a bond indenture that requires it to set aside a certain amount of cash that is reserved for the repayment of bonds at a later date; this cash reserve should not appear in the cash line item.

When a client takes out a line of credit or obtains some other form of debt with a bank, the bank will frequently require that all of the client's bank accounts be shifted to the bank. In addition, the client may be required to maintain a specific minimum cash balance in its accounts with the bank, which is called a compensating balance. The purpose of this balance is to reduce the lending cost for the lender, since the lender can invest the cash located in the compensating bank account and keep some or all of the proceeds. If a client is subject to a compensating balance arrangement with its bank, the terms of the arrangement should be disclosed in the notes accompanying the financial statements.

Internal Controls Used by the Client

As noted earlier in the Auditor Objectives section, the auditor needs to gain an understanding of the client's controls over its cash. Given the unusually high risk of fraud associated with cash, a client may need a large number of controls, including many of the controls noted in the following bullet points. The auditor could use a questionnaire to discuss various aspects of cash controls with the client. The auditor may also want to conduct tests of controls by tracing a selection of cash receipts and disbursements through the business, to see if controls were properly applied at each step in the relevant process. A very cash-specific controls test is to verify that the entire amount of cash receipts recorded for a specific day match the amount stated on the bank deposit slip for the same day.

<u>Accept Cash</u>

- **Open the mail and record cash receipts.** Someone not otherwise involved in the handling or recordation of cash receipts opens the mail, records all cash and checks received, and then forwards the cash receipts to the cashier. To strengthen this control, two people should jointly open the mail.
- **Endorse for deposit only.** The person opening the mail should also immediately endorse all checks received with a "For Deposit Only" stamp, preferably one that also lists the client's bank account number. This makes it much more difficult for someone to extract a check and deposit it into some other account.
- **Direct payments to lockbox.** An excellent control is to set up a lockbox at a bank, and direct customers to send their payments directly to the bank. This eliminates all risk of cash or checks being stolen from within the business.
- **Record cash in cash register.** The primary purpose of a cash register is as its name indicates – it registers the amount of cash received. It also prints a receipt for the customer and visually displays the amount recorded. Therefore, when there is any reasonable expectation for a large number of cash receipts, the client

should always have a cash register available for recording the transactions.

- **Record cash on pre-numbered receipts.** In situations where relatively small quantities of cash are anticipated, it may not be cost-effective to operate a cash register. If so, record cash received on pre-numbered receipts, and be sure to use the receipts consecutively. By doing so, one can scan through the numbers on the receipts to see if any receipts are missing. A missing receipt indicates that cash has not been recorded.
- **Give receipt to customer.** If a customer is paying with cash, cashiers should give customers a copy of the receipt. If the cash is recorded in a cash register, the amount printed on the receipt will match the amount punched into the register. If the cash is recorded on pre-numbered receipts, the form should be a two-part form, so that the amount written on it by the clerk is identical for the versions kept by the customer and the company. Handing over a receipt is a reasonable control, since it means that the recipient might examine the receipt to see if the amount recorded matches what they paid.
- **Match cash register cash to receipts.** Once a sales clerk's shift has ended, a third party should match the amount of receipts recorded by the register to the total amount of cash in the register. This should be recorded on a signed reconciliation form.

<u>Record Cash</u>

- **Apply cash at once.** The cashier should apply cash to customer accounts as soon as the cash is received. Doing so means that the cash will then be shifted off the premises and deposited, leaving little time for anyone to steal it.
- **Apply cash based on check copies.** This control can be applied in two situations. If the client is using a bank lockbox, the bank will either mail copies of all checks and remittance advices received to the client, or it will make them available on a website as scanned images; in either case, the cashier uses these documents as the basis for cash applications. In the second situation, the cashier photocopies all checks, thereby allowing for the immediate deposit of the checks and a somewhat more leisurely application of the payments to outstanding receivables.
- **Record undocumented receipts in a clearing account.** One of the best ways to destroy accounts receivable record accuracy is to apply cash receipts to receivables even when there is no indi-

cation of the invoice numbers to which they should be applied. Instead, these receipts should always be recorded into a clearing account for further review.

- **Match documents.** The cashier should match the initial list of checks generated by the person opening the mail to the related cash receipts journal. This highlights cash that the cashier may not have applied to receivables, and will also spot any cash that was removed between the mailroom and the cashier's office.

Deposit Cash

- **Deposit daily.** If checks or cash are left on-site overnight, there is an increased chance that they may be stolen. To mitigate this risk, always deposit cash and checks at the end of every business day.
- **Lock up cash during transport.** Store all cash in a locked container while transporting it to the bank for deposit. This is not a good control, since someone could steal the entire container. A better approach for transporting large amounts of cash is to hire an armored car company to transport the cash on behalf of the company.
- **Match cash receipts journal to bank receipt.** When funds are deposited at the bank, the bank clerk hands over a receipt for the amount deposited. The person transporting the cash to the bank gives this receipt to the cashier, who compares it to the cash receipts journal. If the numbers do not match, it may mean that the person transporting the cash removed some cash prior to the deposit, though it may also mean that either the cashier or the bank incorrectly recorded the amount of cash.
- **Match remote deposit capture report to cash receipts journal.** If the client is using a check scanner to convert checks to electronic images and deposit them remotely, the scanning software should generate a report that shows the images of all checks scanned. Compare this report to the cash receipts journal to ensure that all checks were scanned and accepted by the bank. Also, store a copy of the report as evidence of transmission to the bank.
- **Destroy scanned checks.** If the client is using remote deposit capture to scan checks on-site, the checks could still be incorrectly included in a normal deposit to the bank. To avoid this, either destroy the scanned checks entirely or perforate or disfigure them to such an extent that they could not reasonably be deposited.

<u>Payment</u>

- **Split check printing and signing.** One person should prepare checks, and a different person should sign them. By doing so, there is a cross-check on the issuance of cash.
- **Store all checks in a locked location.** Unused check stock should *always* be stored in a locked location. Otherwise, checks can be stolen and fraudulently filled out and cashed. This means that any signature plates or stamps should also be stored in a locked location.
- **Secure check-printing equipment.** Some printers are only used for check printing. If so, keep them in a locked location so that no one can print checks and have the integrated signature plate automatically sign the checks.
- **Track the sequence of check numbers used.** Maintain a log in which are listed the range of check numbers used during a check run. This is useful for determining if any checks in storage might be missing. This log should not be kept with the stored checks, since someone could steal the log at the same time they steal checks.
- **Require manual check signing.** A client can require that all checks be signed. This is actually a relatively weak control, since few check signers delve into why checks are being issued, and rarely question the amounts paid. If a client chooses to use a signature plate or stamp instead, it is much more important to have a strong purchase order system; the purchasing staff becomes the de facto approvers of invoices by issuing purchase orders earlier in the payables process flow.
- **Require an additional check signer.** If the amount of a check exceeds a certain amount, require a second check signer. This control supposedly gives multiple senior-level people the chance to stop making a payment. In reality, it is more likely to only introduce another step into the payment process without really strengthening the control environment.
- **Lock up undistributed checks.** If the client does not distribute checks at once, they should be stored in a locked location. Otherwise, there is a risk of theft, with the person stealing the checks modifying them sufficiently to cash them.
- **Initiate banking transactions from a dedicated computer.** It is possible for someone to use keystroke logging software to detect the user identification and password information that a business uses to authorize direct deposit and wire transfer information. To

reduce the risk, set up a separate computer that is only used to initiate transactions with the bank. This reduces the risk that keystroke logging software might be inadvertently downloaded onto the machine from an e-mail or other transaction.

- **Pay from a separate account.** There is a risk that someone could use an ACH debit transaction to move funds out of a client's bank account. To reduce this risk, only shift sufficient funds into a checking account to cover the amount of outstanding checks, ACH payments, and wire transfers that have not yet cleared the bank.
- **Password-protect the direct deposit file.** Some companies accumulate bank account information for their supplier payments in a computer file, while others may access it online in their bank's systems. In either case, the file should be password protected to prevent tampering with the accounts.
- **Different person verifies or approves wire transfers.** When a company authorizes a wire transfer, one person issues the instructions to the bank, and a different person verifies or approves the transaction.

Petty Cash

- **Require a monthly petty cash funding review.** There should not be so much cash in the petty cash box that it represents a serious temptation for someone to steal it. Instead, schedule a monthly review to see if more cash is needed, and set the petty cash amount to a level that should have the remaining cash balance running low by about the time of the review.
- **Require receipts for all cash withdrawals.** When employees request funds from petty cash, they should always submit a receipt in exchange. This receipt may be a receipt from a supplier whom the employee has just paid out of his own pocket, or it may be a form filled out by the employee, stating the purpose of the payout. The amount on the receipt should always match the exact amount paid out, so that the sum of the cash and the receipts in the petty cash box at any time always equal the designated funding level for the box.
- **Employees sign for cash received.** Whenever an employee takes petty cash, he or she must sign a "Received of Petty Cash" form, which states the amount paid out. The petty cash custodian then staples the receipt submitted by the employee to the Received of Petty Cash form. This information packet remains within the pet-

ty cash box, providing evidence that cash was paid out for a certain purpose and that a specific person received the cash. It is later extracted and attached to a journal entry documenting the use of cash.

- **Fill out receipts in ink.** An employee could submit a receipt or Received of Petty Cash form in exchange for cash from the petty cash box, after which the petty cash custodian could increase the amount on the receipt or form and remove the related amount of extra cash. To make it more difficult to alter receipts and forms in this way, require employees to complete them in ink, not pencil.
- **Reconcile petty cash.** An essential step in petty cash processing is to periodically reconcile the account. This involves adding up the amount of cash and receipts in the petty cash box, matching it to the designated petty cash balance, and researching any differences. Petty cash is an area in which errors are common, so a periodic reconciliation is needed to keep the petty cash records close to reality.

We have just stated a large number of controls related to cash. Which are the most important? The most critical single item is to ensure that anyone tasked with handling cash does not also record it. Otherwise, it will be a simple matter for them to steal cash and then cover their tracks by altering the amounts of cash received or disbursed. Second, try to keep cash off the premises by encouraging customers to send their payments to a bank lockbox, or to pay with credit cards. Doing so drastically reduces or even eliminates the amount of cash handled on-site, thereby minimizing fraud. And finally, complete a thorough bank reconciliation for every bank account at least once a month, so that disparities can be spotted and investigated.

It is not sufficient to simply inquire about the existence of the preceding controls. Direct observation of cash transactions is needed to ensure that the controls have been implemented and are operating at all times. If this examination reveals that existing controls are not as effective as anticipated, then it will be necessary to adjust audit procedures, based on a revised risk of material misstatement.

Fraud Issues

Given the liquid nature of cash, there is a higher degree of temptation among client employees to engage in fraudulent activities to steal cash. In these situations, the auditor should present his or findings to the client's management and its audit committee. By doing so, the client is given the opportunity to pursue the matter further. Also, since the client has been officially notified, the auditor is protected from charges of negligence in its conduct of the audit.

In the following sub-sections, we note several fraud schemes that can be used to illegally extract cash from a business or to misrepresent the amount of cash on hand. When reviewing these types of fraud, the auditor should consider the extent to which the receipt of cash makes these fraud schemes more or less likely. For example, a business that handles large amounts of cash from customers is at a much higher risk of fraud. When a higher risk is indicated, the auditor should spend more time investigating the effectiveness of the client's system of controls over cash.

Skimming (No Recordation)

One of the easier frauds for an employee to perpetrate is to remove a portion of any incoming cash before it can be recorded in a company's books. For example, a salesperson could sell inventory and pocket the proceeds without recording the sale. Skimming is especially common when employees can engage in sales activities from an off-site location, after normal business hours, or where there is little or no management supervision. This approach is most common in retail environments where most sales are in cash.

Skimming is a particular problem when the founders of a business engage in it. By doing so, they are pocketing money for which income taxes will never be paid, while the business reports lower profits. Since these individuals are the founders, they can easily circumvent all controls that might otherwise be in place. A further concern in this case is that founders set the ethical tone for the business, so if employees see them stealing cash, the employees are more likely to do so, too.

The existence of skimming can be detected by tracking the gross margin percentage over time. If inventory is being sold and the proceeds pocketed by employees, then the gross margin percentage should trend lower.

One way for a client to minimize skimming is to require payments using credit or debit cards, so that cash is removed from the payment process.

Discounted Sales (Partial Recordation)

A failing of the skimming approach just noted is that inventory leaves the premises without a corresponding sale transaction, resulting in a detectable decline in the gross margin percentage. An employee can instead record a sale in the accounting system in order to log the inventory outflow, but also records a discount against the sale and steals the amount of the discount. For example, an employee sells a widget for $100 and collects $100 from the customer. The person then records the sale as $100, minus a promotional discount of $20, for a net sale of $80. The employee then takes $20. In this case, the only evidence of theft is the presence of an unusually large number of discounts being taken. If the employee engaged in this fraud is careful and only records a few of these discount transactions, the theft will likely not be detected.

The problem can be combatted by requiring management approval for all but the smallest discounts.

Modification of Receipts (Altered Recordation)

If an employee is responsible for all aspects of the cash receipts process, it is not especially difficult for the person to extract incoming cash and then alter the receipts documentation to cover up or obscure the amount of the theft. For example, a few receipts could be selectively damaged, making it impossible for anyone else to reconcile the receipts to the amount actually deposited. If these thefts are kept at a low level, any differences between recorded amounts and actual cash balances will probably be charged to expense with no further investigation.

The main preventive technique to avoid the modification of receipts is to strictly separate responsibility for the various steps in the cash receiving, recordation, and depositing process. By doing so, the person recording receipts has no incentive to alter or destroy records, while the person handling cash has no control over the recordation process. Since there are not enough people in a smaller organization to properly engage in this segregation of duties, smaller enterprises tend to suffer the most from the modification of receipts fraud.

Fake Refunds (Subsequent Recordation)

Cash can be stolen after a sale transaction has been initially recorded. An employee could create a fake refund transaction for a customer and then pocket the payment. For example, an accounting clerk in the receivables area could create a credit memo for a customer, triggering a payment back to the customer. The clerk then extracts the payment from the outgoing pile of checks, forges a signature on the check, signs it over to himself, and deposits the check in his bank account. There are several variations on this concept, such as:

- A product is recorded in the accounting system as having been returned by a customer, which triggers a refund payment.

- A refund is artificially authorized to a customer for a volume discount, which triggers a refund payment.

Fake refunds will only work if there is a control weakness in the system, where the person initiating the refund can reliably intercept the outbound check payment. Otherwise, some of these payments will leak through to the intended customers, who may inquire as to why the payments were sent.

Fake refunds can be stymied if all refund requests must be approved in advance by management and must be accompanied by supporting documentation. In addition, if the fraud involves recording returned goods in the system, ongoing inventory counts should eventually note that the number of inventory units listed in the accounting records as being on hand is routinely higher than the amount actually counted.

Lapping

Lapping occurs when an employee steals cash by taking a payment from one customer and then hides the theft by diverting cash from another customer to offset the receivable from the first customer. This type of fraud can be conducted in perpetuity, since newer payments are continually being used to pay for older debts, so that no receivable involved in the fraud ever appears to be that old.

Lapping is most easily engaged in when just one employee is involved in all cash handling and recordation tasks. This situation most commonly arises in a smaller business, where a bookkeeper may be responsible for all accounting tasks.

If these tasks are split among several people, then lapping can only be conducted when two or more employees are involved. Lapping typically requires that the person engaged in the fraud be involved every day, and so does not take any vacation time. Thus, having a person refuse to take the vacation time that they have earned can be considered a possible indicator of the existence of lapping.

Lapping can be detected by conducted a periodic review of the cash receipts records, to trace payments to outstanding receivables. If there is ongoing evidence that cash receipts are routinely being applied against the wrong customer accounts, then either the cashier is astonishingly incompetent or there is an active lapping scheme in progress.

Bribery Accounts

In rare cases, a client may be underreporting its cash balances by shifting some cash to a separate, unreported and undocumented bank account.

The funds in this account are used to pay bribes to third parties, such as customers, or for other illegal activities. To find these accounts, the auditor will need to trace a sample of cash receipts transactions all the way through from the point of cash receipt to recordation in a bank account. It still may be impossible to track down these accounts if the client is funding them from undocumented sales.

Account Inflation

If a client has old checks outstanding (that have not been cashed by the recipients), the person preparing a bank reconciliation could conceal a cash shortage simply by excluding these checks from the reconciliation. By doing so, the cash book balance is increased by the amount of the excluded checks. It is quite possible that old checks will never be cashed by their recipients, so this simple change to the reconciliation could be made permanent.

The deliberate alteration of a bank reconciliation in this manner can be prevented by forcing the client to conduct a periodic examination of all outstanding checks, and to shift these checks over to an unclaimed checks liability account, for which the offset is a debit to the cash account.

Summary

A large part of the text in this chapter was devoted to controls over cash and cash-related fraud. This was intentional, since cash is subject to a higher level of fraud losses than other assets. The auditor should consider the extent of a client’s controls over cash, as well as the possibility of fraud losses, when designing audit procedures related to cash. When this examination reveals weak controls, the auditor may need to allocate a significant amount of time to the detailed review of a client’s cash asset.

Review Questions

1. Which of the following is <u>not</u> a substantive procedure related to cash?
    - A. Review bank transfers
    - B. Count cash
    - C. Verify valuation
    - D. Confirm balances

2. A salesperson sells inventory and then pockets the proceeds without recording the sale. This is an example of what?
    - A. Lapping
    - B. Skimming
    - C. Receipt modification
    - D. Account inflation

Review Answers

1. A. Incorrect. The auditor should examine any bank transfers for one week on both sides of the balance sheet date.
   B. Incorrect. Depending on materiality, it may be necessary to count the amount of cash on hand as of the balance sheet date.
   C. **Correct.** There is no need to determine the valuation of cash, except in cases where foreign currency is being translated into the reporting currency of the client.
   D. Incorrect. The auditor sends confirmation forms to the financial institutions with which the client does business, asking for verification of account balances.

2. A. Incorrect. Lapping occurs when an employee steals cash by taking a payment from one customer and then hides the theft by diverting cash from another customer to offset the receivable from the first customer.
   B. **Correct.** Skimming involves the removal of incoming cash before it can be recorded in a company's accounting records.
   C. Incorrect. Receipt modification involves altering the text on a receipt to cover up or obscure the amount of a cash theft.
   D. Incorrect. Account inflation is achieved by excluding old checks outstanding from the bank reconciliation in order to increase the ending cash balance.

Chapter 2
The Bank Reconciliation and Proof of Cash

Learning Objectives

- Determine what might be used to identify an employee who is using a company account for his personal use

Introduction

An essential part of the auditing process for cash is to either complete a bank reconciliation for each client account, or (more likely) to review the reconciliation already completed by the client. Doing so provides information about cash inflows and outflows, and also proves whether the client's reported cash balance is correct. In this chapter, we cover the basic process flow for a bank reconciliation, as well as the more detailed proof of cash.

The Reconciliation Process

The essential process flow for a bank reconciliation is to start with the bank's ending cash balance (known as the *bank balance*), add to it any deposits in transit from the company to the bank, subtract any checks that have not yet cleared the bank, and either add or deduct any other reconciling items. Then find the client's ending cash balance and deduct from it any bank service fees, not sufficient funds (NSF) checks and penalties, and add to it any interest earned. At the end of this process, the adjusted bank balance should equal the client's ending adjusted cash balance.

The following bank reconciliation procedure assumes that the bank reconciliation is being created in an accounting software package, which makes the reconciliation process easier:

1. Enter the bank reconciliation software module. A listing of uncleared checks and uncleared deposits will appear.
2. Check off in the bank reconciliation module all checks that are listed on the bank statement as having cleared the bank.
3. Check off in the bank reconciliation module all deposits that are listed on the bank statement as having cleared the bank.

4. Enter as expenses all bank charges appearing on the bank statement, and which have not already been recorded in the client's records.
5. Enter the ending balance on the bank statement. If the book and bank balances match, then post all changes recorded in the bank reconciliation, and close the module. If the balances do *not* match, then continue reviewing the bank reconciliation for additional reconciling items. Look for the following items:
    - Checks recorded in the bank records at a different amount from what is recorded in the client's records.
    - Deposits recorded in the bank records at a different amount from what is recorded in the client's records.
    - Checks recorded in the bank records that are not recorded at all in the client's records.
    - Deposits recorded in the bank records that are not recorded at all in the client's records.
    - Inbound wire transfers from which a processing fee has been extracted.

EXAMPLE

Suture Corporation is closing its books for the month ended April 30. Suture's auditor will prepare its bank reconciliation based on the following issues:

1. The bank statement contains an ending bank balance of $320,000.
2. The bank statement contains a $200 check printing charge for new checks that the company ordered.
3. The bank statement contains a $150 service charge for operating the bank account.
4. The bank rejected a deposit of $500 due to not sufficient funds, and charges the company a $10 fee associated with the rejection.
5. The bank statement contains interest income of $30.
6. Suture issued $80,000 of checks that have not yet cleared the bank.
7. Suture deposited $25,000 of checks at month-end that were not deposited in time to appear on the bank statement.

The auditor creates the following reconciliation:

		Item #	Adjustment to Books
Bank balance	$320,000	1	
– Check printing charge	–200	2	Debit expense, credit cash
– Service charge	–150	3	Debit expense, credit cash
– NSF fee	–10	4	Debit expense, credit cash
– NSF deposit rejected	–500	4	Debit receivable, credit cash

+ Interest income	+30	5	Debit cash, credit interest income
– Uncleared checks	–80,000	6	None
+ Deposits in transit	+25,000	7	None
= Book balance	$264,170		

When the bank reconciliation process is complete, print a report through the accounting software that shows the bank and book balances, the identified differences between the two (most likely to be uncleared checks), and any remaining unreconciled difference. The format of the report will vary by software package; a simplistic layout follows.

Sample Bank Reconciliation Statement

For the month ended March 31, 20x3		
Bank balance	$850,000	
Less: Checks outstanding	–225,000	See detail
Add: Deposits in transit	+100,000	See detail
+/- Other adjustments	0	
Book balance	$725,000	
Unreconciled difference	$0	

The Proof of Cash

A proof of cash is essentially a roll forward of each line item in a bank reconciliation from one accounting period to the next, incorporating separate columns for cash receipts and cash disbursements. It is more complicated than a bank reconciliation. However, it provides a greater degree of detail, and so makes it easier to locate errors than a bank reconciliation. Thus, it may be cost-effective to use a proof of cash when you expect to find a large number of different cash-related errors within an accounting period.

The columns (and formula) used for a proof of cash are:

Beginning balance + Cash receipts in the period –
Cash disbursements in the period
= Ending balance

A sample proof of cash appears in the following exhibit.

Sample Proof of Cash

	Balance 5/31/X2	(+) Cash Receipts	(-) Cash Disbursements	(=) Balance 6/30/X2
Per bank statement	$58,602.17	$78,032.08	$83,821.98	$52,812.27
Deposits in transit:				
at 5/31/X2	1,800.00	-1,800.00		
at 6/30/X2		3,042.00		3,042.00
Outstanding checks:				
at 5/31/X2	-11,603.25		-11,603.25	
at 6/30/X2			10,920.35	-10,920.35
Bank service charges:				
May	58.50		58.50	
June			-60.00	60.00
Per books	$48,857.42	$79,274.08	$83,137.58	$44,993.92

In the preceding proof of cash, the beginning and ending balances are essentially the same as what would be found in a bank reconciliation. The cash receipts column reconciles the client's record of cash receipts with the bank's record of deposits. The cash disbursements column reconciles the client's record of cash disbursements with the bank's record of paid checks.

When used for each line item in a bank reconciliation, the proof of cash highlights areas in which there are discrepancies, and which may therefore require further investigation, and probably some adjusting entries. Examples of these discrepancies are:

- Bank fees not recorded
- Not sufficient funds (NSF) checks not deleted from the deposit records
- Interest income or expense not recorded
- Checks or deposits recorded by the bank in different amounts than what they were recorded by the client
- Checks cashed that the client voided
- Cash disbursements and/or receipts recorded in the wrong account

A proof of cash can also uncover instances of fraud. If there is a difference between the totals, it can indicate the presence of unauthorized borrowings and repayments within the time period covered by a single bank statement. For example, if a client's employee were to illegally withdraw $10,000 from the client's accounts near the beginning of the month for his personal use and replace the funds before the end of the month, the issue would not appear in a normal bank reconciliation as a reconciling item. However, a proof of cash would be more likely to flag the extra cash withdrawal and cash return.

Someone engaged in fraud is less likely to do so near the end of the year, knowing that his or her activities may be spotted by the auditors as part of their year-end procedures. Thus, the auditor can employ a proof of cash in an earlier month if the intent is to search for specific instances of fraud.

Summary

The cash records of a client and its bank are rarely in perfect alignment, since there are typically large numbers of transactions flowing through a bank account, and the bank may be charging fees to the account that the client records on a delayed basis. Consequently, it is essential to prepare a bank reconciliation for every client bank account. A proof of cash is not as necessary, unless there is a concern that someone at the client is engaged in fraudulent activities. If fraud is suspected, then consider preparing a proof of cash for a period of time earlier in the year, when the person is more likely to have been engaged in fraud, rather than at year-end.

Review Questions

1. Which of the following is <u>not</u> a step to be completed in a bank reconciliation?
    A. Create columns for cash receipts and cash disbursements
    B. Record as expenses all bank charges appearing on the bank statement
    C. Check off all checks that are listed on the bank statement as having cleared the bank
    D. Check off all deposits that are listed on the bank statement as having been received

Review Answers

1. A. **Correct.** Only a proof of cash includes columns for cash receipts and cash disbursements. This is a greater level of detail than is found in a bank reconciliation.
   B. Incorrect. By recording bank charges listed on the bank statement, these charges no longer represent a difference between the bank and book balances.
   C. Incorrect. It is necessary to check off all checks that are listed on the bank statement as having cleared the bank, in order to create a list of uncleared checks.
   D. Incorrect. It is necessary to check off all deposits that are listed on the bank statement as having been received by the bank, in order to create a list of deposits in transit.

Glossary

B

Bank balance. The ending cash balance appearing on a bank statement for a bank account.

Bank reconciliation. The process of matching the balances in an entity's accounting records for a cash account to the corresponding information on a bank statement.

Bank statement. A document that a bank periodically issues to its customers, detailing account activity and ending balances.

Bank transfer schedule. A schedule of transfers between the bank accounts of an organization.

C

Cash equivalent. A highly liquid investment having a maturity of three months or less.

Compensating balance. A minimum bank account balance that a borrower agrees to maintain with a lender.

Confirmation. A letter sent by an auditor to a bank, asking for account balance information.

I

Inherent risk. The probability of loss based on the nature of an organization's business, without any changes to the existing environment.

K

Kiting. The practice of depositing and drawing checks at multiple banks in order to take advantage of the time required for the second bank to collect funds from the first bank.

L

Lapping. When an employee steals cash by diverting a payment from one customer, and then hides the theft by diverting cash from another customer to offset the receivable from the first customer.

Lockbox. A service offered by a bank, where it receives and processes checks on behalf of a company.

P

Petty cash. A small amount of cash that is kept on the premises of a business to make incidental cash purchases and reimbursements.

Proof of cash. A roll forward of each line item in a bank reconciliation from one accounting period to the next, incorporating separate columns for cash receipts and cash disbursements.

R

Remote deposit capture. When a company uses a check scanner and scanning software to create an electronic image of each check that it wishes to deposit. The company then transmits the scanned check information to its bank instead of making a physical deposit.

S

Skimming. The removal of a portion of incoming cash before it can be recorded in a company's accounting records.

Substantive procedures. Procedures that are performed by an auditor to detect whether there are any material misstatements in accounting transactions.

W

Window dressing. Actions taken to improve the appearance of a company's financial statements.

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