**Chapter-One: Audit of Cash and Marketable Securities**

* 1. **Sources and nature of cash -** Cash normally includes general cash accounts, payroll accounts, petty cash fund, saving accounts, marketable securities and other cash equivalents such as money market funds, certificate deposit, saving certificates and other similar types of deposits. Receipt and payment of cash is a significant part of an independent financial statement audit. This is because these receipts and payments affect almost all accounts relating to the income and expenditure and a number of asset and liability accounts. On other hand, the liquid nature of cash increases the risk of undetected fraud. The auditor has to recognize this factor in developing appropriate audit program accordingly.

**1.2. Auditors’ objectives of auditing cash**

The auditor’s objectives in the audit of cash are to

1. Consider the internal control over cash transactions
2. Substantiate the existence of the recorded cash
3. Establish the completeness of the recorded cash
4. Determine that the client has the rights to the recorded cash
5. Establish the clerical accuracy of the cash schedules
6. Determine that the presentation and disclosure of cash, including restricted funds (such as compensating balances and band sinking funds) are appropriate

In auditing the cash transactions, the auditor has to be extremely careful with the possibility of the overstatements of the cash payments and understatements of the cash receipts. The auditor has to verify the ending balance of cash thoroughly as there is a possibility of including fictitious checks in the cash on hand at the year-end. The possible irregularities of the cash transactions are

* 1. Receipt of cash without proper recording
  2. Payment may not have made with actual withdrawal
  3. Duplicate payments
  4. Overpayments or payments to fictitious persons
  5. Payments for the personal expenditures of officers and related parties

**1.3. Internal control over cash transactions**

Most of the functions of the cash handling are the responsibility of the finance department and these functions include handling and depositing of cash receipts, signing of checks, investing idle cash and maintaining custody of cash, marketable securities and other liquid assets. In achieving a good internal control over cash transactions are the following

* Do not permit any one employee to handle a transaction from beginning to end
* Separate cash handling from record keeping
* Centralize receiving of cash to the extent possible
* Record cash transactions on a timely basis
* Encourage customers to obtain receipts and observe cash register totals
* Deposit cash receipts daily
* Make all disbursements by check or electronic fund transfer with the exception of small expenditures from petty cash
* An appropriate official should review the completed reconciliations promptly.
* Forecast expected cash receipts and disbursements and investigate variances from forecasted amounts

### Internal control over cash receipts

1. **Cash sales**: Control over cash sales is important when two or more employees participate in each transaction with the customer. Some organizations use a centrally located cashier who receives cash from the customer along with a sales ticket prepared by another employee. If the ticket or the sales checks are serially numbered and all numbers accounted for, this separation of responsibility for the transaction is an effective means of preventing fraud. In many establishments, the nature of business is such that one employee must make over the counter sales, deliver the merchandise, receive cash and record the transaction. In this situation dishonesty may be discouraged by proper use of cash registers or electronic point of sale systems. The protective features of the cash registers include
   1. Visual display of the amount of the sale is in full view of the customer
   2. A printed receipt, which the customer is urged to take with the merchandise
   3. Accumulation of a locked in total of the day’s sales
2. **Electronic Point-of –Sale (POS) System**: In many establishments, various type of electronic cash registers, including on-line computer terminals are being used. With these registers, an electronic scanner is used to read the sales price and other data from specially prepared product tags. The sales person need only pass the tag over the scanner for the register to record the sale at the product’s price. Thus the risk of a salesperson recording sales at erroneous prices is substantially reduced. Besides providing strong control over cash sales, electronic registers often may be programmed to perform numerous other control functions such as verification of the status of the customers, update the accounts receivable and perpetual inventory records, provide special printouts accumulating sales data by product line, salesperson, department and type of sale etc.
3. **Collection from credit customers**: For most of the establishments, a major part of sales are made on credit and collection from these credit customers is a tedious task. Most of the collections are received through mail. This poses a major threat if one employee is allowed to receive, deposit, and record the credits to the customer’s accounts. Hence a proper internal control system should be established leaving no room for misappropriation.
4. **Lockbox Control over Cash Receipts**: Business receiving a large volume of cash through the mail often uses a lockbox system to strengthen the internal control and hasten the depositing of cash receipts. The lockbox is actually a post office box controlled by the company’s bank. The bank picks up mail at the post office box several times a day, credits the company’s checking accounts for cash received and send the remittance advices to the company. The internal control system of the company is strengthened by the fact that the bank has no access to the company’s accounting records.

**Internal control over the cash disbursements**

The cash disbursements of the company should be made by check, electronic fund transfer and for minor items petty cash should be used.

1. **Payment by check**: the principal advantage of requiring disbursement by check is obtaining evidence or receipt from the payee in the form of an endorsement on the check. The other advantages of using check for payment are
   1. The centralization of disbursement authority in the hands of a few designated officials who is authorized to sign the check
   2. A permanent record of payments
   3. Reduction in the amount of cash kept on hand

In order to have a proper control of payments,

* + - The checks should be serially pre-numbered and all the numbers in the series should be accounted for.
    - Unissued prenumbered checks should be adequately safeguarded against theft or misuse.
    - Voided checks should be defaced to eliminate any possibility of further use and filed in the regular sequence of paid checks.
    - A computer or a check-protecting machine should print the amount on the check.
    - The check should be crossed before issue.
    - The authorized official should sign the check only after reviewing the supporting documents and put some identification to prevent them from being produced a second time.
    - The check should reach the official for signature after completing all formalities except signature
    - The check should not be returned to the accounting department who prepares them after signature
    - If a check signing machine is used, a key should be required to retrieve the signed checks and facsimile signature plate should be removed from the machine when the machine is not in use
    - Frequent bank reconciliation statements should be prepared to have adequate internal control over cash. The reconciliation should be prepared by a employee who do not have a role in the cash transactions.

1. **Electronic fund transfer**: Electronic funds transfer system is that process fund related transactions for customers as an alternative to paying by checks. The funds are electronically transferred between companies’ bank accounts. This is done through electronic data interchange, which allows the interchange of data from one company’s computer to another. These systems have the advantage over paying by check by reducing the paper work, processing costs and delays. But the disadvantage is that it requires an extensive set of computer network controls relating to the system access and data entry. It also requires backup controls for situations in which a system breakdown occurs.
2. **Internal control for petty cash**: internal control over payments from an imprest petty cash fund is achieved at the time the fund is replenished to its fixed balance rather than at the time of making the payments. The documents supporting each payment will be reviewed for completeness and authenticity when the custodian of the petty cash funds requests for replenishment of the fund. The petty cash payments may not be material for the financial statement and hence the auditor may test one or more replenishment transactions by examining petty cash vouchers.

#### 1.4. Audit program for cash

The most appropriate procedures for a particular audit will be guided by the nature of the internal controls in force and by other circumstances of the engagement. The following is the audit program for the verification of cash transactions

**A. Consider the internal control for cash transactions**

**1**. Obtain an understanding of the internal control structure for cash

The auditors may prepare a written description or flow chart about a control in force based on the questions held with the owners and employees; and through observations.

For cash - Are all persons receiving cash?

Receipts -Does the employee assigned to the opening of

incoming mail prepare a list of all checks and

money received?

Among the - Are each day’s receipt deposited intact and

questions that without delay by an employee other than

might be asked accounts receivable bookkeeper?

by auditors include - Other related questions

For cash - Are all disbursement (except from petty cash)

disbursements by prenumbered checks?

-Are all voided checks are preserved and filed?

-Are all checks are signed by selected executives or not?

-Whether checks are mailed directly to the

Payees after being signed

-Questions about internal control over

- Disbursements for payroll, dividends, as well as bank reconciliation and other

related

After auditors have verified their understanding of the cash receipts and disbursements cycles, they will observe whether there is appropriate segregation of duties and inquirers as to who perform various functions throughout the year.

They also inspect various documents and reconciliations that are important to the client’s internal control over cash receipts disbursements. After auditors have obtained an understanding of the controls relating to cash, they will consider the types of misstatements that may occur.

**2**. Assess control risk and design additional tests of controls for cash

**3.** Perform additional tests of controls for those controls which the auditors plan to consider supporting their planned assessed levels of control risk such as:

* + 1. Test the accounting records and reconciliations by performance
    2. Compare the details of a sample of cash receipts listings to the cash receipts journal, account receivable postings and authenticated deposit slips
    3. Compare the details of a sample of recorded disbursements in the cash payments journal to accounts payable postings, purchase orders, receiving reports, invoices and paid checks.

**4.** Reassess control risk and modify substantive tests for cash

**B. Perform substantive tests of cash transactions and balances**

**The objective of major substantive testing procedures of cash transactions and balances are given in the following table.**

|  |  |
| --- | --- |
| **Substantive Tests** | **Primary Audit Objective to be Addressed** |
| 5. Obtain analyses of cash balances and reconcile them to the general ledger | Clerical accuracy |
| 6. Send standard confirmation forms to financial institutions to verify amounts on deposit.  7. Obtain or prepare reconciliations of bank (financial institutions) accounts as of the balance sheet date and consider needs to reconcile bank activity for additional months.  8. Obtain cut-off bank statements containing transactions of at least seven days subsequent to balances sheet date.  9. Count and list cash on hand | Existence and right |
| 10. Verify the client’s cut-off of cash receipts and cash disbursements  11. Analyze bank transfer for last week of audit year and first week of the following year. | Existence and right  Completeness |
| 12.Investigate any check representing large or unusual payments to related parties  13. Evaluate proper financial statements presentation and disclosure of cash. | Presentation and disclosure |

The factor of materiality applies to audit work on cash as well as to other aspects of the audit. Even if the cash balance shown in the financial statements is relatively small, the auditor may have to devote a larger proportion of the total audit hours to cash transactions. This is due to the amount of flow of cash into and out of the business during the year is often great than for any other account. Several reasons exist to explain the auditors’ traditional emphasis on cash transactions. Liabilities, revenue, expenses and most other assets flow though the cash account i.e. most of these items either arise or result in cash transactions. The examination of cash transactions assists the auditors in the substantiation of many other items in the financial statements.

Another reason contributing to extensive auditing of cash is that cash is the most liquid of all assets and offers the greatest temptation for theft, embezzlement and misappropriation. For liquid assets, the inherent risk is very high and auditors tend to respond to high-risk situations with more intensive investigation. If the fraud in cash transactions is material, then only the detection of fraud is relevant to the overall fairness of the financial statements of the client. The auditor can avoid wasting audit time on matters that are not material to the financial statements and that may better be pursued by client personnel.

* Since cash generally has a high degree of inherent risk, more audit time is devoted to the audit of the account than is indicated by its dollar amounts.
* Internal control over cash receipts should provide assurance that all cash received is recorded promptly and accurately. Control over sales is strongest when two or more employees participate in each transaction, or when a cash register or an electronic point of sale system controls collections.
* When a cash receipt consists of checks received through the mail, the receipts should be listed and controlled by personnel who do not maintain cash or accounts receivables records. The control listing should be reconciled to the entries in the cash receipts journal and deposit records from the financial institutions.
* Internal control over cash disbursements is best achieved when all payments are made by check or well- controlled electronic fund transfers, except for payments of minor items from petty cash funds.
* Separation of the functions of presentation of the payments from that of signing checks tends to prevent errors and fraud in cash disbursements.

**1.5 Audit of Marketable securities**

From the viewpoints of the auditors, the most important group of investments consists of bonds and shares as they are found more frequently and usually are of greater value than other kinds of investment holding. Commercial paper, mortgage deeds, surrender value of the insurance policies are other type of investments. For the business organization, the idle cash has to be utilized for some profitable purposes. Management may also choose to maintain some investments in marketable securities on a semi permanent basis. The length of time such investments are held may be determined by current security yields and by the company’s income tax position, as well as by its cash requirements.

#### 1.5.1. The Auditors’ objectives in Examination of marketable securities

The auditors’ objectives in the examination of marketable securities are to:

1. Consider internal control over marketable securities.
2. Determine the existence of recorded marketable securities and that the client has rights to the securities.
3. Establish the completeness of recorded marketable securities.
4. Determine that the valuation of marketable securities is in accordance with the cost market, or equity method of accounting, as appropriate.
5. Establish the clerical accuracy of schedules of marketable securities.
6. Determine that the presentation and disclosure of marketable securities, including current/non current classifications are appropriate.

In conjunction with their audit of marketable securities, the auditors will also verify the related accounts of interest income and dividends, accrued interest revenue, and grains and losses on the sale of securities.

The liquid nature of marketable securities makes the potential for irregularities high. Auditors must coordinate their cash and marketable securities audit procedures to detect any possible irregularities involving unauthorized substation between the accounts. The overall audit approach is one of assessing control risk for securities, inspecting certificates, confirming securities held by third parties such as banks, and determining the appropriate valuation of the securities.

**1.5.2. Internal Control for Marketable Securities:**

The major elements of adequate internal control over marketable securities include the following:

1. Separation of duties between the executive authorizing purchases and sales of securities, the custodian of the securities, and the person maintaining the record of investments.
2. Complete detailed records of all securities owned and the related revenue from interest and dividends.
3. Registration of securities in the name of the company.
4. Periodic physical inspection of securities by an internal auditor or an official having responsibilities for the authorization, custody or record keeping of investments.

**1.5.3. Audit Program for Securities**

The following are the procedures typically performed by auditors to achieve the objectives:

##### A. Consider internal control for securities

1. Obtain an understanding of internal control for securities.
2. Assess control risk and design additional tests of controls for securities.
3. Perform additional tests of controls for those controls the auditors plan to consider to support their planned assessed levels of control risk such as:
4. Trace several transactions for purchases and sales of securities through the accounting systems.
5. Inspect reports by internal auditors on their periodic inspection of securities.
6. Inspect monthly reports on securities owned, purchased, and sold and amounts of revenue earned and budgeted.
7. Reassess control risk and modify substantive tests for securities.

**B. Perform substantive tests of securities transactions and year-end balances**.

1. Obtain or prepare analyses of the securities investment account and related revenue accounts and reconcile to the general ledger.
2. Inspect securities on hand.
3. Obtain confirmation of securities held by others.
4. Vouch selected purchases and sales of securities during the year.
5. Verify the client’s cutoff of securities transactions.
6. Perform analytical procedures.
7. Make independent computations of revenue from securities
8. Determine the market values of securities at date of balance sheet.
9. Evaluate the method of accounting for securities.
10. Evaluate financial statement presentation and disclosure of securities.