

# CHAPTER 5

## *The Why and How of Auditing Cash*

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Now we shift gears. We move from risk assessment and planning to auditing transaction areas. Cash is a good place to start.

Auditing cash tends to be straightforward. We usually just obtain the bank reconciliations and test them. How? By vouching the outstanding items to the subsequent month's bank statement. Additionally, we send bank confirmations. But are such procedures always adequate? Hardly.

Recall the Parmalat and ZZZZ Best Carpet Cleaning frauds. In those businesses, cash thefts were covered up with fake bank statements and fake bank confirmation responses. Millions were lost and audit firm reputations were sullied.

### **How to Audit Cash**

In this chapter, we will take a look at the following:

- Primary cash assertions
- Cash walkthrough
- Directional risk for cash
- Primary risks for cash
- Common cash control deficiencies
- Risk of material misstatement for cash
- Substantive procedures for cash
- Common cash work papers

## Primary Cash Assertions

First, let's look at assertions.

The primary relevant cash assertions include:

- Existence
- Completeness
- Rights
- Accuracy
- Cutoff

Of these assertions, I believe existence, accuracy, and cutoff are most important. The audit client is asserting that the cash balance exists, that it's accurate, and that only transactions within the period are included.

Classification is normally not a relevant assertion. Why? Because cash is almost always a current asset. But when bank overdrafts occur, classification can be in play. Negative cash balances are sometimes shown as liabilities on the balance sheet.

## Cash Walkthrough

Second, perform your risk assessment work in light of the potential relevant assertions.

In performing cash walkthroughs, ask questions such as:

- Are timely bank reconciliations performed by competent personnel?
- Are *all* bank accounts reconciled?
- Are the bank reconciliations reviewed by a second person?
- Are all bank accounts on the general ledger?
- Are transactions appropriately cut off at period-end (with no subsequent period transactions appearing in the current year)?
- Is there appropriate segregation between persons handling cash, recording cash, making payments, and reconciling the bank statements?

- What bank accounts were opened in the period?
- What bank accounts were closed in the period?
- Who has the authority to open and close bank accounts?
- Are there any restrictions on the bank accounts?
- What persons are authorized to sign checks?
- What is the nature of each bank account (e.g., payroll bank account)?
- Are there any cash equivalents?
- Were there any held checks (checks processed and signed but not mailed) at period-end?
- Who makes deposits and how? Who records them?

As we ask questions, we also inspect documents (e.g., bank reconciliations) and make observations (e.g., who is doing what?).

If control weaknesses exist, we create audit procedures to address them. If during the walkthrough we review three monthly bank reconciliations and they all have errors, we will perform *more* substantive work to prove the year-end bank reconciliation. We might, for example, vouch *every* outstanding deposit and disbursement.

### **Directional Risk for Cash**

Third, consider the directional risk of cash. What is directional risk? It's the potential bias that a client has regarding an account balance. A client might desire an overstatement of assets and an understatement of liabilities since each makes the balance sheet appear healthier.

The directional risk for cash is that it is overstated. So, perform procedures to ensure that cash is not overstated, such as testing bank reconciliations.

## Primary Risks for Cash

Fourth, think about the risks related to cash. Primary risks include:

- Cash is stolen
- Cash is intentionally overstated to cover up theft
- Cash accounts are intentionally omitted from the general ledger
- Cash is misstated due to errors in the bank reconciliation
- Cash is misstated due to improper cutoff

## Common Cash Control Deficiencies

Fifth, think about control deficiencies noted during your walkthroughs and other risk assessment work. In smaller entities, it is common to have the following control deficiencies:

- The same person receipts and/or disburses monies, records those transactions in the general ledger, and reconciles the related bank accounts
- The person performing the bank reconciliation does not possess the skill to perform the duty
- Bank reconciliations are not timely performed

## Risk of Material Misstatement for Cash

Sixth, using the information you gathered, assess your risks of material misstatement. The assertions that concern me the most are existence, accuracy, and cutoff. So my RMM for these assertions is usually moderate to high.

My response to higher risk assessments is to perform certain substantive procedures: namely, bank confirmations and testing of the bank reconciliations. As RMM increases I examine *more* of the period-end bank reconciliations and *more* of the outstanding reconciling items.

## Substantive Procedures for Cash

And finally, it's time to determine your substantive procedures in light of your identified risks.

My customary audit tests are as follows:

- Confirm cash balances
- Vouch reconciling items to the subsequent month's bank statement
- Ask if all bank accounts are included on the general ledger
- Inspect period-end deposits and disbursements for proper cutoff

The auditor should send confirmations directly to the bank. Some individuals create fake bank statements to cover up theft. Those same persons provide false confirmation addresses. Then the confirmation is sent to an individual (the fraudster) rather than the bank. Once received, the fraudster replies to the confirmation as though the bank is doing so. You can lessen the chance of fraudulent confirmations by using Confirmation.com, a company that specializes in bank confirmations. Alternatively, you might Google the confirmation address to verify its existence.

Agree the confirmed bank balance to the period-end bank reconciliation (e.g., December 31, 20X7). Then, agree the reconciling items on the bank reconciliation to the subsequent period bank statement. For example, examine the January 20X8 bank statement activity when clearing the December 20X7 reconciling items. Finally, agree the reconciled balance to the general ledger.

The auditor might examine the reconciling items by viewing online bank statements. (Read-only rights can be given to the auditor.)

I don't normally test cash controls (e.g., test of bank reconciliation controls) for effectiveness, but you do have that option. If such

controls are tested and you determine they are effective, then some of the substantive tests listed above may not be necessary.

## **Common Cash Work Papers**

My cash work papers normally include the following:

- An understanding of cash-related internal controls
- Risk assessment of cash at the assertion level
- Documentation of any control deficiencies
- Cash audit program
- Bank reconciliations for each significant account
- Bank confirmations
- Disclosure checklist

## **Auditing Cash - A Simple Summary**

- The primary relevant cash assertions include existence, completeness, rights, accuracy, and cutoff
- Perform a walkthrough of cash by making inquiries, inspecting documents, and making observations
- The directional risk for cash is that it is overstated
- Primary risks for cash include:
  - Cash is stolen
  - Cash is intentionally overstated to cover up theft
  - Cash accounts are intentionally omitted from the general ledger
  - Cash is misstated due to errors in the bank reconciliation
  - Cash is misstated due to improper cutoff
- The substantive procedures for cash should be responsive to the identified risks. Common procedures include:
  - Confirmation of cash
  - Vouching reconciling items to the subsequent month's bank statement

- Asking if all bank accounts are included in the general ledger
- Inspecting period-end deposits and disbursements for proper cutoff

Now you know how to audit cash. Next we'll see how to audit receivables and revenues.