

CHAPTER 7

The Why and How of Auditing Investments

The complexity of auditing investments varies. For entities with simple investment instruments, auditing is easy. Your main audit procedure might be to confirm balances. Complex investments, however, require additional work such as auditing values. As investment complexity increases, so will your need for stronger audit team members. Regardless, you need an audit methodology.

How to Audit Investments

In this chapter, we will take a look at:

- Primary investment assertions
- Investment walkthroughs
- Directional risk for investments
- Primary risks for investments
- Common investment control deficiencies
- Risk of material misstatement for investments
- Substantive procedures for investments
- Common investment work papers

Primary Investments Assertions

First, let's look at assertions.

Primary relevant investment assertions include:

- Existence
- Accuracy

- Valuation
- Cutoff
- Completeness

The audit client asserts that the investment balances exist, that they are accurate and properly valued, and that only investment activity within the period is recorded.

While investment balances in the financial statements are important, disclosures are also vital, especially when the entity owns complex instruments. Thus, the completeness and accuracy assertions are relevant.

Investment Walkthroughs

Second, perform your risk assessment work in light of the potential relevant assertions. In performing investment walkthroughs, ask questions such as:

- What types of investments are owned?
- Are there any unusual investments? If yes, how are they valued?
- Is a specialist used to determine investment values?
- Who determines the classification of investments (i.e., trading, available for sale, held to maturity) and how?
- Do the persons accounting for investment activity have sufficient knowledge to do so?
- Are timely investment reconciliations performed by competent personnel?
- Are *all* investment accounts reconciled from the investment statements to the general ledger?
- Who reconciles the investment accounts and when?
- Are the reconciliations reviewed by a second person?
- Are all investment accounts on the general ledger?
- How does the entity ensure that all investment activity is included in the general ledger (appropriate cutoff)?

- Who has the ability to transfer investment funds and what are the related controls?
- Is there appropriate segregation of duties for:
 - Persons that record investments,
 - Persons that buy and sell investments, and
 - Persons that reconcile the investment statements?
- What investment accounts were opened in the period?
- What investment accounts were closed in the period?
- Who has the authority to open or close investment accounts?
- Are there any investment restrictions (externally or internally)?
- What persons are authorized to buy and sell investments?
- Does the entity have a written investment policy?
- Does the company use an investment advisor? If yes, how often does management interact with the advisor? How are investment fees determined?
- Are there any investment impairments?
- Who is responsible for investment disclosures and do they have sufficient knowledge to carry out this duty?
- Are there any cost or equity-method investments?

As we ask questions, we also inspect documents such as investment statements and make observations such as who reconciles the investment statements to the general ledger.

If control weaknesses exist, we create audit procedures to address them. For example, if during the walkthrough we note that there are improperly classified investments, then we will create audit procedures to address that risk.

Directional Risk for Investments

Third, consider the directional risk of investments. The directional risk for investments is that they are overstated. So, in performing your audit procedures, perform procedures to ensure that balances are properly stated.

Primary Risks for Investments

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

- Investments are stolen
- Investments are intentionally overstated to cover up theft
- Investment accounts are intentionally omitted from the general ledger
- Investments are misstated due to errors in the investment reconciliations
- Investments are improperly valued due to management's lack of knowledge regarding accounting standards and the investments themselves
- Investments are misstated due to improper cutoff
- Investment disclosures are not accurate or complete

Common Investment Control Deficiencies

Fifth, think about control deficiencies noted during your walkthroughs and other risk assessment work. It is common to have the following investment control deficiencies:

- One person buys and sells investments, records those transactions, and reconciles the investment activity
- The person overseeing investment accounting does not possess sufficient knowledge or skill to properly perform the duty
- Investment reconciliations are not performed timely or improperly
- The company does not employ sufficient assistance in valuing complex assets such as hedges or alternative investments

Risk of Material Misstatement for Investments

Sixth, assess your risks of material misstatement with the information you've gathered.

The assertions that concern me the most are existence, accuracy, valuation, cutoff, and completeness. So my RMM for these assertions is usually moderate to high.

Substantive Procedures for Investments

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

My customary audit tests include:

- Confirming investment balances and agreeing them to the general ledger
- Inspecting period-end activity for proper cutoff
- Using an investment specialist to value complex instruments (if any)
- Vetting investment disclosures with a current disclosure checklist

I don't normally test controls related to investments. If controls are tested and you determine they are effective, then some of the substantive procedures may not be necessary.

Common Investment Work Papers

My investment work papers normally include the following:

- An understanding of investment-related internal controls
- Risk assessment of investments at the assertion level
- Documentation of any control deficiencies
- Investment audit program
- Investment reconciliations
- Investment confirmations
- Valuations performed by specialists
- Documentation of the specialist's experience, competence, and objectivity
- Disclosure checklist

Auditing Investments - A Simple Summary

- The primary relevant investment assertions include existence, accuracy, valuation, cutoff, and completeness
- Perform a walkthrough of investments by making inquiries, inspecting documents, and making observations
- The directional risk for investments is an overstatement
- Primary risks for investments include:
 - Investments are stolen
 - Investments are intentionally overstated to cover up theft
 - Investment accounts are intentionally omitted from the general ledger
 - Investments are misstated due to errors in the investment reconciliations
 - Investments are improperly valued due to management's lack of knowledge regarding accounting standards and the investments themselves
 - Investments are misstated due to improper cutoff
 - Investments disclosures are not accurate or complete
- The substantive procedures for investments should be responsive to the identified risks. Common procedures include:
 - Confirming investments
 - Inspecting period-end activity for proper cutoff
 - Using an investment specialist to value complex instruments
 - Vetting investment disclosures with a current disclosure checklist

Now you know how to audit investments.

Next, we'll see how to audit property