CHAPTER 10

Cash and Financial Investments

Review Questions

10–1 The following circumstances might cause a client to understate assets:

(1) Management of a privately held company may be motivated to understate assets so as to minimize income taxes.

(2) Bank accounts may not be recorded so as to make possible unrecorded, illegal payments.

(3) Management may wish to "manage" earnings by "deferring" income until a subsequent year.

10–2 Work on cash is likely to be more extensive than one might expect because (only 2 required):

(1) Although the amount of cash shown on the balance sheet may appear relatively small, the amounts flowing into and out of the cash account during the year are often greater than for any other account. Nearly all business transactions eventually require a cash settlement. Thus, the year-end cash balance is not the only measure of materiality.

(2) Cash is the most liquid of assets and offers the greatest temptation for theft, embezzlement, and misappropriation.

(3) The examination of cash transactions assists the auditors in the substantiation of many other items in the financial statements because these other items either arise from or result in cash transactions.

10–3 The quoted statement is not correct. The purpose of an audit is to gather evidence that will enable the auditors to express an opinion on the financial statements, and not to pursue an extended investigation of minor fraud. If the auditors determine that the fraud could not have a material effect upon the financial statements, they should review the situation with the client before investigating further. This discussion will alert the client to the situation, protect the auditors from charges of incompetence, and avoid wasting audit time on matters that are not material with respect to the financial statements and that may better be pursued by client personnel.

10–4 The two independent records of the client's cash transactions are: (1) the client's own cash records, and (2) the bank's records of the client's account, as evidenced by the monthly bank statements and the year-end bank confirmation available to the auditor.

10–5 A lockbox system is one in which a post office box is controlled by a company's bank at which cash remittances from customers are received. The bank receives the remittances, immediately credits the cash to the company's bank account, and forwards the remittance advices to the company.
Chapter 10 - Cash and Financial Investments

10–6 The description of internal control should be prepared first. The areas selected for testing and the size of audit samples will be determined according to the relative quality of internal control over cash receipts, cash disbursements, and cash forecasting. The purpose of tests of controls is to determine the extent to which controls allegedly in use are actually operating effectively.

10–7 (1) All cash that should have been received was in fact received and recorded promptly and accurately.
(2) Cash disbursements are made only for authorized purposes and are recorded properly.
(3) Cash balances are maintained at adequate but not excessive levels by forecasting expected cash receipts and payments related to normal operations. The need for obtaining loans or for investing excess cash is thus made known on a timely basis.

10–8 a. Accounting department; b. Accounting department; c. Finance department; d. Finance department; e. Finance department.

10–9 The Check Clearing Act for the 21st Century allows financial institutions to destroy physical copies of checks and use an electronic (substitute) copy for check clearing purposes. The audit implications are:
1. Auditors may have to rely on electronic (substitute) copies of checks for audit evidence.
2. Kiting becomes virtually impossible when the client’s financial institutions use electronic processing, because it takes hours (or less) rather than days to clear a check.

10–10 The discovery of large checks drawn payable to the treasurer and charged to Miscellaneous Expense suggests the possibility that the funds went to the treasurer personally and were not expended for business purposes. The auditors should ascertain whether there is adequate documentary evidence supporting the charge to Miscellaneous Expense, such as purchase orders, invoices, receipts, receiving reports, etc. The auditors should also determine whether the disbursement was specifically approved by the president or other officer besides the treasurer before issuance of the checks. When fraud has been detected, the auditor should assure himself/herself that the audit committee of the board of directors is adequately informed.

10–11 Lapping involves withholding cash receipts and covering such withholding by a subsequent entry. This covering entry creates a shortage as to some other customer or source of receipts and it will in turn be covered, as was the first shortage. The result is a constant shifting of the shortage from each account to a more current account as illustrated.
10–12 The old outstanding checks should be eliminated as they cause unnecessary clerical work in each bank reconciliation and also represent a threat to good internal control. A dishonest employee may conceal a cash shortage merely by omitting old outstanding checks from the bank reconciliation. The auditor should prepare a list of the old checks and ask the client to contact the payees and request them to present the checks for payment. If this is not feasible, the checks should be eliminated by restoring the appropriate amount to the cash balance and setting up a special liability account.

10–13 The Standard Form to Confirm Account Balance Information with Financial Institutions requests the financial institution to confirm amounts on deposit, whether accounts are interest-bearing and/or subject to withdrawal, and direct liabilities (loans) of the client from the financial institution.

10–14 Compensating balance arrangements can be confirmed on a separate letter directed to an official at the financial institution that is knowledgeable of the arrangements (usually, the client's loan officer).

10–15 Upon discovery of an apparent shortage during the count of cash, the first action by the auditors should be to review any computations and recount the funds in question to rule out any possibility of an error in the count.

A second step is to give the employee responsible for the fund an opportunity to explain the situation. Discrepancies of a small amount may be disposed of by transfer to an over-and-short account. If the shortage is material and no satisfactory explanation is immediately forthcoming, the matter should promptly be called to the attention of the auditor-in-charge, who will take up the matter with officers of the client company.

10–16  

a. Obtaining a cutoff bank statement permits the examination of many checks listed as outstanding in the bank reconciliation and establishes the collectibility of customers' checks included in undeposited receipts on the balance sheet date. Any unrecorded outstanding checks at year-end will also be disclosed by the cutoff statement.

b. By comparing paid checks returned with the bank statement to the list of checks outstanding in the previous reconciliation, the auditors obtain assurance that the cash cutoff at the beginning of the bank reconciliation period is accurate, and that cash shortages are not being obscured by manipulation of the outstanding checks list.
c. Tracing all bank transfers for a short period before and after the end of the year is designed to disclose "kiting," whereby a check drawn on one bank is not recorded as a disbursement as of the balance sheet date, although the deposit of the check in another bank is properly recorded.

d. The purpose of investigating checks representing large or unusual payments to related parties is to determine that the transactions (a) were properly authorized and recorded and (b) are adequately disclosed in the financial statements.

10–17 To verify the client's cutoff of cash receipts, the auditors may either (1) be on hand to count the undeposited cash receipts on the last business day of the period, or (2) examine the cutoff bank statement to determine that deposits reported as being in transit at year-end were received by the bank on the following business day. When a client has numerous branches, the auditors usually employ a combination of these procedures in verifying the cutoff at the various locations.

10–18 The term "window dressing" refers to actions taken shortly before the balance sheet date that are designed specifically to improve the cash position or in other ways to create an improved financial picture of the company. Some forms of window dressing are legitimate (such as making all possible shipments and billings to customers at year-end). Other methods of window dressing (such as holding the cash journals open) constitute misrepresentation.

Another example of window dressing occurs when a corporate officer who has borrowed money from the corporation repays the loan just before the balance sheet date and then promptly obtains a new loan shortly after the balance sheet date.

10–19 Adequate internal control over investment processes should include the following features:

(1) Separation of custody of securities from recordkeeping.
(2) Detailed records of securities owned and related revenue from interest and dividends.
(3) Authorization of purchases and sales by the investment committee.
(4) Registration of securities in name of company.
(5) Periodic inspection of securities by an internal auditor or official not charged with custody of securities or recordkeeping.
(6) Periodic review of investment activities by the internal auditor or another independent official.
(7) A budget for investment revenue.

10–20 The monthly report relating to securities transactions should show:

(1) Securities owned at the beginning of the month.
(2) Purchases, sales, gains, and losses during the month.
(3) Dividends and interest received.
(4) Securities owned at the end of the month.
Information to be noted by the auditors during their inspection of securities includes (a) name of issuing company, (b) face amount, (c) serial number, (d) maturity date, (e) date and rate of interest or dividends, (f) presence of all future interest coupons, and (g) name in which registered.

In accordance with AICPA AU 620 (PCAOB 336), the auditors should perform procedures to evaluate the professional qualifications and reputation of the specialist—the securities appraiser. In addition, the auditors should obtain an adequate understanding of the methods and assumptions used by the specialist and evaluate their relevance and reasonableness in relation to the auditors’ findings and conclusions. For example, the auditors should assure that the model considers all aspects of risk, such as counterparty credit risk, risk of adverse changes in market factors, and risk of losses from legal or regulatory action. In addition, the auditors should evaluate the relevance, completeness, and accuracy of any significant information provided to the specialist by the client to be used in appraising the options.

The audit of financial investments can be very complex and present special risks requiring specialized skill or knowledge in performing audit tasks such as:

- Identifying controls at service organizations that provide financial services and are part of the client’s information system.
- Obtaining an understanding of information systems for securities and derivatives that are highly dependent on computer technology.
- Applying complex accounting principles to various types of financial investments.
- Understanding the methods of determining the fair values of financial investments, especially those that must be valued using complex valuation models.
- Assessing inherent and control risk for assertions about derivatives used in hedging activities.

Therefore, the auditors may decide that the assistance of specialists either within or outside the firm is needed to assist in the audit of complex financial investments.

The auditors can make an independent computation of dividends earned during the year by reference to dividend record books published by investment advisory services.

If a security or derivative is not marketable (has no active market), management may obtain an appraisal of fair value from a securities valuation firm (a specialist). In such cases, the auditors should refer to AICPA AU 620 (PCAOB 336), which requires that they consider the professional qualifications and reputation of the appraiser and obtain an understanding of the methods and assumptions used. When a valuation model, such as an option-pricing model, is used, the auditors should assess the reasonableness and appropriateness of the model and evaluate the reasonableness of the underlying assumptions. The auditors should make sure that the model considers all aspects of risk, such as counterparty credit risk, risk of adverse changes in market factors, and risk of losses from legal or regulatory action. In addition, the auditors should evaluate the relevance, completeness, and accuracy of any significant information provided to the specialist by the client to be used in appraising the options.
Questions Requiring Analysis

10–26  

a. The prelisting of cash receipts strengthens a company's internal control by safeguarding against unauthorized removals of incoming cash by employees whose duties would permit them to conceal the removals. An effective system of prelisting cash receipts normally provides for an employee with no other cash duties to open the mail and prepare a listing of the individual receipts included. One copy of the prelisting must be controlled and later used by a responsible employee with no related duties to ascertain that all cash received in the mail has been entered in the cash journal and credited by the bank.

b. The following duties should be excluded from the work of all employees who are in a position to intercept cash receipts from trade customers before they are recorded so that none of the same employees will have an opportunity also to conceal any unauthorized removals:

1. Maintaining the cash receipts journal.
2. Totaling the columns of the cash receipts journal.
3. Preparing any cash receipts records to be used in posting.
4. Originating credit memoranda for customers' accounts.
5. Maintaining the sales and/or sales returns and allowances record.
6. Preparing any sales and/or sales returns and allowances records to be used in posting.
7. Footing any sales and/or sales returns and allowances records to be used in posting.
8. Approving credit memorandums, write-offs or other journal entries affecting trade accounts receivable.
9. Posting charges or credits to the customers' individual accounts.

With an office staff of twenty employees, Fluid Controls, Inc., should be able to assign duties in a manner that will avoid inappropriate combinations of tasks for any one employee. Observing the basic concepts of internal control should not prevent the controller from achieving economy of operations. To ignore these basic rules may, in fact, prove to be quite costly.

10–27

a. The principal weakness in the internal control is that bank reconciliations are prepared by the same employee who records cash disbursements and prepares checks for signature. If another employee had reconciled bank statements, Mills would not have been able to conceal the existence of the forged check. Bank reconciliations should be prepared by an employee with no other responsibilities for cash transactions. Another weakness in internal control is that checks are allowed to remain outstanding indefinitely. The outstanding check list should be reviewed periodically and payment should be stopped on checks outstanding for more than a reasonable period of time (90 days is often used for this purpose).

b. Audit procedures that might disclose the fraudulent disbursement include:

1. Tests of controls of the client's periodic bank reconciliations.
2. Accounting for the serial numbers of all checks issued.
3. Vouching all checks paid by the bank during a test period.
4. Determining that all checks listed as outstanding at the beginning of a test period were paid during the period or listed as outstanding at the end of the period.

Procedures (2), (3), and (4) are often associated with the test period(s) covered by a proof of cash.
10–28 There is no assurance that the lapping activities of the cashier will be discovered during the annual audit. Since no shortage exists as of the balance sheet date, detection will be difficult. A procedure that might disclose the fraud would be a comparison of the individual checks listed on duplicate deposit tickets with the credits to customers' accounts. Since a test of this nature would probably not be made for more than a small sample of control listings it is likely that the "borrowing" and subsequent restoration of borrowed funds might go undetected.

10–29 Cash shortages are sometimes concealed by intentionally omitting an outstanding check from the year-end bank reconciliation or by understating the amount of one or more outstanding checks. These omitted or understated checks will, however, probably be paid by the bank early in January and returned with the cutoff bank statement. The audit procedure of comparing the paid checks returned with the cutoff bank statement and dated December 31 or earlier with the list of outstanding checks at December 31 would disclose any omissions or understatements in that list.

10–30 The quoted statement is not accurate. In their work on cash, auditors are primarily concerned with the risk of an overstatement of the cash balance. The listing of a non-existent or fictitious check on the outstanding list would have the effect of understating the client's cash position, because too large an amount for outstanding checks would be deducted from the balance per bank, resulting in understatement of the adjusted balance. The other element of the quoted statement relating to the auditors' concern over the possible omission of a deposit in transit is also in error. To omit a deposit in transit would cause an understatement of the year-end cash balance.

If the quoted statement were revised into acceptable form, it would read along the following lines: "When auditors are verifying a client's bank reconciliation, they are particularly concerned with the possibility that an outstanding check may be omitted or that a non-existent deposit in transit may be included."

10–31

(a) The CPAs will use the January 10 (year 2) cutoff bank statement in their review of the December 31 bank reconciliation to determine whether:

1. The beginning balance on the cutoff bank statement agrees with the "balance per bank" on the December 31 reconciliation.
2. The December 31 bank reconciliation includes those paid checks that were returned with the cutoff bank statement and are dated or bear bank endorsements prior to January 1.
3. Deposits in transit are cleared within a reasonable time.
4. Interbank transfers have been considered properly in determining the December 31 adjusted bank balance.
5. Other reconciling items that had not cleared the bank at December 31 (such as bank errors) clear during the cutoff period.

(b) The CPAs may obtain other information by:

1. Investigating unusual entries on the cutoff bank statement.
2. Examining paid checks, particularly noting unusual payees or endorsements.
3. Reviewing other documentation supporting the cutoff bank statement.
Among the transactions or circumstances that these procedures might disclose are:

(1) Irregular payments or payments related to matters which the CPA should investigate. For example, the CPA would want to learn the reason for an unusual legal fee or a payment to a company officer.

(2) Borrowings in the new fiscal year or repayment of recorded or unrecorded loans outstanding at year-end.

(3) NSF checks applicable to the year ended December 31.

(4) Material expenditures during the cutoff period.

10–32 The outstanding checks said by the controller to have been distributed after December 31 should be reversed to the extent that they were actually distributed after that date. The primary purpose of the reversal is to properly cut off the cash and show the proper cash balance. Showing the correct cash balance eliminates "window dressing"; recorded but undistributed checks would distort the current ratio by reducing both cash and accounts payable. But, if the checks had been mailed prior to year-end, an overdraft should be revealed and not be eliminated by improper journal entries.

10–33

a. Checks outstanding at the end of the test period should be added to the bank figure for checks paid (Column 3) to arrive at the accounting record's figure for disbursements. The outstanding checks should also be deducted from the November 30 balance per bank (Column 4).

b. The deposit in transit at the beginning of the test period should be added to the October 31 balance per bank (Column 1) and deducted from deposits for the period (Column 2). The deposit in transit is deducted from the bank's November deposits because the cash receipt was recorded in the accounting records in October rather than in November.

c. A check issued and paid during the test period is already included in both the bank's figure for checks paid and disbursements per the accounting records. Therefore, this check does not appear as a reconciling item in the proof of cash. While drawing checks payable to "Cash" is a poor practice, it does not affect the treatment of the check in a bank reconciliation.

d. The $1,800 in NSF checks returned by the bank should be deducted from checks paid by the bank (Column 3), since these returned items are not considered disbursements in the accounting records. The $1,450 redeposited in November should be deducted from deposits (Column 2); redepositing checks does not constitute another receipt of cash in the accounting records. The $350 redeposited in December was cash on hand at November 30 and should be added to the November 30 balance per bank (Column 4) to attain the cash balance per the accounting records.

10–34

a. The major elements of adequate internal control over derivatives include the following:

- Formal investment policies that limit the nature of derivative transactions to those that are consistent with the risk appetite of management.
- An investment committee of the board of directors that authorizes and reviews financial investment activities for compliance with investment policies.
- Separation of duties between the executive authorizing purchases and sales of derivative instruments, the custodian of the securities, and the person maintaining the records of investments.
- Complete detailed records of derivative instruments owned and the related provisions and terms.
- Determination of appropriate accounting for complex financial instruments by competent
personnel.
- Periodic audits by the internal auditors to determine compliance with investment policies and evaluate level of risk assumed.

b. The auditors may perform substantive procedures such as the following:

- Obtain or prepare an analysis of the investment account and related revenue, gain and loss accounts and reconcile to the general ledger.
- Confirm with Hanover's commodity broker that it is holding the instrument.
- Vouch transactions (the purchase and any others) during the year relating to such contracts.
- Review investment committee minutes and reports to determine that the transaction was properly authorized.
- Make independent computations of revenue from the derivative (if any).
- Inspect documentation of management’s intent to classify the derivative transaction as a hedging activity.
- Evaluate the method of accounting for the futures contract.
- Test the valuation of the futures contract.
- Evaluate financial statement presentation and disclosure of the futures contract.

10–35 a. The purpose of a bank transfer schedule is to trace bank transfers to disclose overstatement of cash balances resulting from kiting. When a check drawn on one bank is deposited in another, several days (called the float period) usually pass before the check clears the bank on which it is drawn. During this period, the amount of the check is included in the balance on deposit at both banks. Kiting refers to the manipulations that utilize such temporarily overstated bank balances to conceal a cash shortage or meet short-term cash needs.

b. The following checks should be investigated

Check No. 2020: The increase in one bank account and decrease in the other bank account should occur in the same accounting period. Here the cash receipt was recorded prior to year-end, while the disbursement was recorded after year-end. As a result of recording the debit and credit parts of the transaction in different accounting periods, cash is overstated at year-end. Also, since the debit (deposit) was recorded prior to year-end, the auditors must investigate where the offsetting credit occurred.

Check No. 3271: The entry recorded as a deposit by the bank as of year-end, should also be reflected in the accounting records prior to year-end. An entry such as this one might indicate the concealing of a cash shortage due to a misappropriation.

10–36 a. Two potential audit problems are indicated by the schedule. First, the shares of Beta Corp. are not publicly traded. Therefore determining the fair value of the securities will require the use of a valuation model and perhaps a specialist. Second, the Continental Airlines Convertible Bonds are securities with imbedded derivatives. Accordingly, management should account for the option separately. This will require the use of valuation models to determine the values of the bonds and the options separately. It may also require the use of a specialist.

b. If a security is not marketable (has no active market), management may obtain an appraisal of fair value from a securities valuation firm. In such cases, the auditors should refer to the auditing standards on using the work of a specialist, which require that they consider the professional qualifications and independence of the appraiser and obtain an understanding of
the methods and assumptions used. When a valuation model is used, the auditors should assess the reasonableness and appropriateness of the model and consider the reasonableness of the underlying assumptions. The auditors should make sure that the model considers all aspects of risk, such as risk of adverse changes in market factors and risk of losses from legal or regulatory action.

**Objective Questions**

10–37 Multiple Choice Questions

**a.** (1) A bank lock box is a post office box controlled by a company’s bank at which cash remittances from customers are received. With such a system the bank collects the remittances, immediately credits the cash to the company’s bank account, and forwards the remittance advices to the company. Use of a bank lockbox system makes it extremely difficult for employees to divert cash receipts since those cash receipts are sent directly to the post office box controlled by the bank. Answer (2) is incorrect because remittance advices may be prenumbered, but since they come from various customers, they do not have one overall sequence for the client. Answers (3) and (4), bank reconciliations, and daily deposit of cash receipts, are controls, but controls that ordinarily are not as effective as a bank lockbox system.

**b.** (2) The auditors will determine whether each voucher is stamped “paid” by the check signer to avoid a situation in which supporting documents are used a second time to elicit a second payment.

**c.** (4) When checks are signed they should not be returned to the accounting department. This control is used so as to avoid a situation in which the accounts payable department fabricates documents, and then collects the checks. Not returning the checks makes it more difficult for this sort of fraud in that the perpetrator must also establish a “safe” address for the check to be mailed to. Answer (1) is incorrect because control is stronger if individuals who are otherwise independent of the cash function prepare and review the monthly bank reconciliation. Answer (2) is incorrect because, as discussed, the checks should not be returned to accounts payable. Answer (3) is incorrect because the individual signing the checks needs access to the supporting documents so he or she can determine whether the expenditure is proper.

**d.** (4) The general ledger will not have information on the balance per bank. The cutoff bank statement, year-end bank statement and bank confirmation will all include information on the balance per bank.

**e.** (3) Unless all negotiable assets are verified at one time, an opportunity exists for a dishonest officer or employee to conceal a shortage by transferring it from one asset category to another a step ahead of the auditors. For example, marketable securities could be pledged as collateral for a loan. The cash thus obtained could be included with other cash being counted by the auditors. After the cash count, the cash derived from the securities could be removed and used to redeem the pledged securities which would then be available for counting by the auditors. Of course, this type of manipulation could hardly be carried on unless there were weaknesses in internal control.

Answer (1) is incorrect because counting cash in advance of the balance sheet date does not relate to kiting. Answer (2) is not persuasive because accounts payable
cannot be substituted for cash, as can negotiable assets. Answer (4) is not correct because there is no particular significance to the amount of cash on hand on the day the bank confirmation letters happen to be returned.

\[ \text{(f)} \quad \text{The use of cash registers and tapes helps assure that all sales of a retail store are recorded. Answer (2) is incorrect because the cash has already been recorded. Answer (3) is incorrect because the procedure only deals with recorded deposits and, therefore, the completeness assertion is not addressed as directly as in answer (1). Answer (4) is incorrect because one would not expect the cash balance in the general ledger to agree with the bank confirmation request due to items in transit and checks outstanding.} \]

\[ \text{(g)} \quad \text{The individual who reconciles the bank account should not be involved in the processing of cash receipts or disbursements. Therefore, answer (1) is correct. All of the other functions are compatible with reconciliation responsibilities.} \]

\[ \text{(h)} \quad \text{Lapping will result in a delay in the recording of specific remittance credits in the financial records, but the checks will be deposited in the bank as they are received. Therefore, a comparison of the checks deposited to the credits to customer accounts will likely uncover the scheme.} \]

\[ \text{(i)} \quad \text{Having the securities held in safekeeping by a bank or stockbroker provides strong internal control because they are not available to employees responsible for maintaining the accounting records of the securities. Thus the separation of the custody of securities from the accounting function is complete.} \]

\[ \text{(j)} \quad \text{The investment committee of the board of directors is not involved in the routine of making buy and sell decisions and can therefore review the transactions objectively. On the other hand, the chief operating officer, the controller, and the treasurer may be closely associated on a daily basis with the financial executive responsible for the investment decisions.} \]

\[ \text{(k)} \quad \text{Because of the liquidity of many securities, the auditor should insist that a client representative be present in order to acknowledge the receipt of securities returned. In the event of subsequent “disappearance” of a security the auditor will not be a suspect.} \]

\[ \text{(l)} \quad \text{Comparing the recorded amount of dividend revenue with dividend record books (published by investment advisory services) provides evidence of the amount of dividend revenue that should have been received during the year. It is virtually impossible to confirm the receipt of dividends with the company paying those dividends.} \]

10–38 Task-Based Simulation

\[ \text{(a)} \quad \text{Answer (2) is correct because use of a lock box system decreases the risk of asset misappropriation by having customer payments deposited directly into the bank.} \]

\[ \text{(b)} \quad \text{Answer (4) is correct because reliance upon Wingo Corporation represents a risk since Wingo may find either a substitute product to replace SSC’s QSand product or develop its own such product.} \]

\[ \text{(c)} \quad \text{Answer (1) is correct because the simulation emphasizes the fact that sales are} \]
dependent upon economic growth.

d. (1) Answer (1) is correct because the competition that has led to decreased sales prices may ultimately create a difficult situation for CCS.

e. (2) Answer (2) is correct because the pressure to obtain the refinancing creates pressure on management.

f. (1) Answer (1) is correct because current earnings, which are low as compared to the past, may have created pressure on management to at least exceed the previous year’s net income.

10–39 Adapted AICPA Task-Based Simulation

a. E. Kiting involves manipulations causing an amount of cash to be included simultaneously in the balance of two or more bank accounts. Kiting schemes are based on the float period—the time necessary for a check deposited in one bank to clear the bank on which it was drawn. To detect kiting, a bank transfer schedule is prepared to determine whether cash is improperly included in two accounts.

b. D. A comparison of the cleared checks to the year-end bank reconciliation will identify checks that were not mailed until after the first week of the subsequent year because most of those checks will not be returned with the cutoff statement and will appear to remain outstanding an abnormally long period of time.

c. H. Among the terms confirmed for such a borrowing arrangement will be information on liens.

d. K, L. A reply to the second request, or information from the credit agency, may confirm the existence of the new customer. Also, examination of shipping documents will reveal where the goods were shipped, and ordinarily to which party.

e. P. Observing the payroll check distribution on a surprise basis will assist in detection since the auditor will examine details related to any paychecks not picked up by employees.

f. Q. Vouching data in the payroll register to document authorized pay rates will reveal situations in which an employee is earning income at a rate that differs from the authorized rate.

g. A. A comparison of the details of the cash receipts journal to the details on the daily deposit slips will reveal a circumstance since the details will have been posted to accounts during the last week of the year under audit.

h. U. When vouchers are processed for merchandise not ordered or received, there will be no supporting purchase orders and receiving reports and this will alert the auditor to the problem.

i. B. Scanning the debits to the fixed asset accounts and vouching selected amounts will reveal repairs that have improperly been capitalized.

j. A, J. Lapping involves concealing a cash shortage by delaying the recording of journal entries for cash receipts. Since lapping includes differences between the details of postings to the cash receipts journal and corresponding deposit slips, comparing these records will reveal it. Also, confirmation requests may identify lapping when payments of receivables (as indicated by confirmation replies) appear to have taken too much time to be processed.

k. E. Increasing cash by drawing a check in this manner is a form of kiting (see answer 1). Preparation of a bank transfer schedule will assist the auditor in identifying such transactions.
Chapter 10 - Cash and Financial Investments

1. **J, L.** Confirmations will identify overstated accounts receivable when customers disagree with the recorded balance due. Also, the related overstated sales will not have shipping documents indicating that a shipment has occurred.

10–40 Adapted AICPA Task-Based Simulation

a. **D, I.** The balance per bank may be traced to a standard form used to confirm account balance information with financial institutions and to the cutoff statement (on which will appear the beginning balance).

b. **A, G, H, I, J.** One of the deposits in transit does not appear on the cutoff bank statement (the 9/29/X5 deposit for $4,500). Accordingly, that deposit should be traced to the cash receipts journal (procedure A), the reason for the delay should be investigated (procedure G), and supporting documents should be inspected (procedure H). Both deposits should be traced to and from the bank reconciliation and the cutoff statement (procedures I and J).

c. **B, G, H, I, J.** One of the checks does not appear on the cutoff statement (check #988 dated 8/31/X5 for $2,200). Accordingly, that check should be traced to the cash disbursements journal (procedure B), the reason for the delay should be investigated (procedure G), and supporting documents should be inspected (procedure H). All checks should be traced to and from the bank reconciliation and cutoff statement (procedures I and J).

d. **E.** The credit memo from the bank for the note collected should be investigated.

e. **E, I.** The credit for the check that was charged by the bank for an incorrect amount should be investigated on both the bank credit memo and on the cutoff statement.

f. **C.** The only source of the balance per books is the cash general ledger account as of 9/30/X5.

10–41

a. **(1)** Answer (1) is correct because a bank transfer schedule, which is appropriately used when a client has two or more bank accounts, is prepared to detect kiting, manipulations that cause cash to be included simultaneously in the balance of two or more bank accounts.

b. **(5)** Answer (5) is correct because the middle two columns of a four-column proof of cash are used to reconcile cash receipt and disbursement totals between company records and bank records.

c. **(7)** Answer (7) is correct because the standard bank confirmation includes questions that help the auditor to verify both year-end cash and liability balance information.

d. **(6)** Answer (6) is correct because a bank cutoff statement includes information on bank transactions for the first 7–10 days after year-end, and accordingly is used to verify reconciling items on the year-end bank reconciliation.

e. **(8)** Auditors search for related party transactions to determine whether they are properly authorized, recorded, and disclosed.
Problems

10–42 Task-Based Simulation

<table>
<thead>
<tr>
<th>Check Number</th>
<th>Reply</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>Year-end total cash is properly stated.</td>
<td>The entire transfer cleared prior to year-end.</td>
</tr>
<tr>
<td>2002</td>
<td>Year-end total cash is properly stated.</td>
<td>The total cash on the books is proper, although the check has not yet cleared City Bank and is outstanding at year-end.</td>
</tr>
<tr>
<td>6734</td>
<td>Year-end total cash is overstated.</td>
<td>The cash is in both book accounts at year-end, having been recorded in City Bank, but not taken out of 1st City.</td>
</tr>
<tr>
<td>3580</td>
<td>Year-end total cash is overstated.</td>
<td>The cash is in both book accounts at year-end, having been recorded in City Bank, but not taken out of 1st City.</td>
</tr>
<tr>
<td>2008</td>
<td>Year-end total cash is properly stated.</td>
<td>Transfer recorded properly on books; there should be an outstanding check (City Bank) and a deposit in transit (3rd National).</td>
</tr>
<tr>
<td>2009</td>
<td>Year-end total cash is properly stated.</td>
<td>Although the cash is in the wrong accounts on the books at year-end, the misstatement of each cancels itself out.</td>
</tr>
<tr>
<td>4005</td>
<td>Year-end total cash is understated.</td>
<td>At year-end the cash is recorded as disbursed on 3rd National, but not received until the following year by City Bank.</td>
</tr>
</tbody>
</table>

10–43 Task-Based Simulation

<table>
<thead>
<tr>
<th>Issues</th>
<th>Potential Issue</th>
</tr>
</thead>
<tbody>
<tr>
<td>A 2.</td>
<td>Reconciliation balance was not properly agreed to the December 31, general ledger balance.</td>
</tr>
<tr>
<td>B 4.</td>
<td>Reconciliation was not reviewed in a timely manner.</td>
</tr>
<tr>
<td>C 6.</td>
<td>Reconciliation has unsubstantiated unrecorded items.</td>
</tr>
<tr>
<td>D 7.</td>
<td>Reconciliation contains aged items that should have been added to the bank balance.</td>
</tr>
<tr>
<td>E 11.</td>
<td>Reconciliation was not agreed to bank statement balance at the appropriate date.</td>
</tr>
<tr>
<td>F 15.</td>
<td>Reconciliation contains stale checks.</td>
</tr>
</tbody>
</table>

Improper replies:

<table>
<thead>
<tr>
<th>Incorrect Potential Issue</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Reconciliation is not mathematically accurate.</td>
<td>No mathematical error exists.</td>
</tr>
<tr>
<td>3. Reconciliation line item “Other reconciling items” is left blank.</td>
<td>This will remain blank if there are no such items.</td>
</tr>
<tr>
<td>5. Reconciliation was improperly approved as reviewer had a conflict of</td>
<td>Evan Monroe seems to have appropriate experience and his position makes him a logical candidate to review the reconciliation. Simply because he has a</td>
</tr>
</tbody>
</table>

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interest. personal bank account at the bank does not seem to present a conflict of interest.

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>8. Reconciliation was improperly prepared by someone with a conflict of interest.</td>
<td>There is no indication that Joe Smith has a conflict of interest.</td>
</tr>
<tr>
<td>9. Reconciliation does not contain a proper title.</td>
<td>The title seems appropriate.</td>
</tr>
<tr>
<td>10. Reconciliation does not agree to the cash disbursement subsidiary ledger.</td>
<td>Ordinarily there is no cash disbursement subsidiary ledger.</td>
</tr>
<tr>
<td>12. Reconciliation does not include January, year 3 reconciliation items.</td>
<td>The reconciliation does include deposits in transit and outstanding checks.</td>
</tr>
<tr>
<td>13. Reconciliation was not prepared in a timely manner.</td>
<td>The reconciliation was prepared shortly after year-end.</td>
</tr>
<tr>
<td>14. Reconciliation was prepared by an inexperienced individual.</td>
<td>Joe Smith’s experience seems appropriate to allow him to effectively prepare the reconciliation.</td>
</tr>
</tbody>
</table>

10–44 SOLUTION: Internal Control, Substantive Procedures (Estimated time: 20 minutes)

a. (1) Segregation of the custody and recordkeeping functions for marketable equity securities is designed to prevent personnel from being in a position to abstract the client's securities and alter the records to conceal the abstraction.

(2) Registration in the company's name is designed to prevent employees with custody of securities from using them for their own purposes. For example, securities registered in the name of the custodian easily could be used as collateral for a personal loan to that custodian.

(3) An analysis of the investment committee minutes and reports may disclose unrecorded purchases and sales of securities or other financial instruments, as well as transactions that are not consistent with company policies. This procedure is especially important if the client engages in derivatives because transactions giving rise to derivatives may not involve the payment or receipt of cash.

b. (1) Segregation of duties is tested by making inquiries as to which employees performed specific tasks throughout the year, and observing personnel performing those tasks. The auditors also should make inquiries as to who performs assigned tasks under unusual circumstances, such as prolonged illness of an employee.

(2) Registration of securities in the name of the company could be tested by making inquiries regarding the policy and observing securities on hand, preferably on a surprise basis.

(3) Investment committee minutes may be obtained from the client.
c. (1) and (2). Both of these weaknesses might be compensated for by performing a surprise count of marketable securities. A comparison could be made of the serial numbers on securities on hand with those recorded from previous examinations. Misuse of the client's securities during the year also might be indicated by analytical procedures, such as comparison of the client's rate of earning on investments to prevailing rates.

(3) This weakness is likely to be very significant in the sense that unauthorized purchases and sales of derivative transactions may be involved. The auditors will expand the analysis of derivative transactions to determine exactly the nature of transactions that have occurred. Depending upon the nature of these transactions, this may involve an analysis of all investments and possibly a search of receipts and disbursements transactions related to such transactions. In addition, because many such transactions may not involve the receipt or payment of cash, it is essential that the auditors understand the natures of the transactions involved.

10–45 SOLUTION: Reliable Auto Parts, Inc. (Estimated time: 30 minutes)

<table>
<thead>
<tr>
<th>RELIABLE AUTO PARTS, INC.</th>
<th>Corrected Proof of Cash for April, 20X0</th>
<th>July 31, 20X0</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance</td>
<td>Checks</td>
<td>Balance</td>
</tr>
<tr>
<td>3/31/9X</td>
<td>Deposits</td>
<td>4/30/9X</td>
</tr>
<tr>
<td>Per bank statement</td>
<td>$ 71,682.84</td>
<td>$68,119.40</td>
</tr>
<tr>
<td>Deposits in transit:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>At 3/31/X0</td>
<td>2,118.18</td>
<td>(2,118.18)</td>
</tr>
<tr>
<td>At 4/30/X0</td>
<td></td>
<td>4,918.16</td>
</tr>
<tr>
<td>Outstanding checks:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>At 3/31/X0</td>
<td>(14,888.16)</td>
<td>(14,888.16)</td>
</tr>
<tr>
<td>At 4/30/X0</td>
<td></td>
<td>22,914.70</td>
</tr>
<tr>
<td>Bank service charges:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>March, 20X0</td>
<td>22.18</td>
<td>22.18</td>
</tr>
<tr>
<td>April, 20X0</td>
<td></td>
<td>(19.14)</td>
</tr>
<tr>
<td>Note receivable collected</td>
<td></td>
<td></td>
</tr>
<tr>
<td>by bank 4/30/X0</td>
<td>(18,180.00)</td>
<td>(18,180.00)</td>
</tr>
<tr>
<td>NSF check of customer L. G. Waite, charged back by bank 3/31/X0, redeposited and cleared 4/3/X0</td>
<td>418.19</td>
<td>(418.19)</td>
</tr>
<tr>
<td>Per Books</td>
<td>$59,353.23</td>
<td>$45,689.98</td>
</tr>
</tbody>
</table>
### 10–46 SOLUTION: Sunset Building Supply (Estimated time: 25 minutes)

#### a.

**SUNSET BUILDING SUPPLY**  
Comparison of Checks and Disbursements  
December 31

<table>
<thead>
<tr>
<th>Checks returned or still outstanding:</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Returned in cutoff statement</td>
<td>$50,440</td>
<td></td>
</tr>
<tr>
<td>Outstanding checks on 1/14 ($3,600 + $8,200)</td>
<td>11,800</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$62,240</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Disbursements per client records:</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Outstanding checks on 12/31</td>
<td>$20,758</td>
<td></td>
</tr>
<tr>
<td>Issued between 1/1 and 1/14</td>
<td>31,482</td>
<td></td>
</tr>
<tr>
<td></td>
<td>52,240</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Excess of checks returned or outstanding over disbursements per client records</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>$10,000</td>
<td></td>
</tr>
</tbody>
</table>

#### b.

Possible explanations for the excess of checks returned or still outstanding over the disbursements indicated by the client's records include (only four required):

1. A check (or checks) may have been recorded at the wrong amount(s). The auditors should ascertain whether this is an isolated error or is indicative of poor recordkeeping procedures by the client. An adjusting entry should be proposed debiting the appropriate account(s) and crediting Cash for $10,000.

2. The client may have failed to record one or more cash disbursements. Unrecorded disbursements constitute a significant weakness in internal control. The auditors should determine how such errors (or manipulations) are able to occur and propose corrective action to the client. In addition, the auditors may request a second cutoff statement at a later date to determine the existence of any additional unrecorded disbursements. All unrecorded disbursements should be vouched to determine the appropriate financial statement presentation and an adjusting entry proposed debiting the appropriate accounts and crediting Cash.

3. Checks may have been omitted from the outstanding checks list on December 31, or the total of the list could be underfooted. Such an error would conceal a $10,000 cash shortage and raise suspicions of employee fraud. The auditors should call the matter to the attention of appropriate client officials and determine whether the client wishes to have the auditors investigate further. The appropriate adjusting entry would recognize a loss and reduce the overstated cash balance.

4. The cash disbursements journal may be underfooted for the first part of January. The auditors should prove the footings and, if an error exists, propose an adjusting entry debiting the appropriate account and crediting Cash.

5. The amount of a check may have been raised by the payee. The auditors should call this alteration to the attention of the client and propose an adjusting entry recognizing a loss and crediting Cash. (The prospects for recovering stolen funds seldom justify recording a receivable.)

6. The bank may have charged the bank account with a check drawn on another account. The auditors should advise the client to notify the bank of the error; no adjusting entry is necessary.
Chapter 10 - Cash and Financial Investments

(7) A stop payment order may have been ignored by the bank. Again, this is a bank error and no adjusting entry is necessary.

10–47 SOLUTION: Ginko Company (Estimated time: 35 minutes)

(1) Review answers to questions on confirmation requests to determine proper recognition in accounting records and the necessity for financial statement disclosure.

(2) Make inquiries as to compensating balances and restrictions.

(3) Obtain copies of the bank reconciliations as of the balance sheet date, and:

\ a. Trace the adjusted book balances to the general ledger balances.
\ b. Compare the bank balances to the opening balances on the cutoff bank statement.
\ c. Compare the bank balances to the balances on the confirmations.
\ d. Trace amounts of deposits in transit to the cutoff bank statements and ascertain whether the time lags are reasonable.
\ e. Verify the clerical accuracy of the reconciliations.
\ f. Obtain explanations for unusual reconciling items, including checks drawn to "bearer," "cash," and related parties.
\ g. Trace checks dated prior to the end of the period that were returned with the cutoff statements to the list of outstanding checks.
\ h. Investigate outstanding checks that did not clear with the cutoff bank statements.
\ i. Examine a sample of checks for payee, amount, date, authorized signatures, and endorsements to determine any deviations from company policy.

(4) Prepare a bank transfer schedule from a review of the cash receipts and disbursements journals, bank statements, and related paid checks for the last few days before and the first few days after the year-end, and:

\ a. Review the schedule to determine that the deposit and disbursement of each transfer is recorded in the proper period.
\ b. Trace incomplete transfers to the schedule of outstanding checks and deposits in transit.

In-Class Team Cases

10–48 SOLUTION: Steven Smith Co. (Estimated time: 20 minutes)

<table>
<thead>
<tr>
<th>Transfer</th>
<th>Understated, Overstated or Correct</th>
<th>Example (Many others are possible.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>Correct</td>
<td><em>Book entries:</em> The transfer was recorded in the accounting records as a check written on the disbursing bank on December 29 and a corresponding cash receipt recorded to receiving bank on that date. <em>Bank entries:</em> The check was taken to the receiving bank on December 29 and deposited. The accounts are both in the same bank, and accordingly the transaction was recorded in both accounts as of that date.</td>
</tr>
<tr>
<td>b.</td>
<td>Correct</td>
<td><em>Book entries:</em> On December 30 a check was written on the disbursing bank, recorded as a cash disbursement in the cash disbursements records and recorded as a receipt in the cash receipts records.</td>
</tr>
<tr>
<td></td>
<td>Bank entries: The check was deposited in the receiving bank the next day, December 31. On January 2, the check was received by the disbursing bank.</td>
<td></td>
</tr>
<tr>
<td>---</td>
<td>---</td>
<td></td>
</tr>
<tr>
<td>c. Understated</td>
<td>Book entries: On December 31 a check was written on the disbursing bank to transfer cash to the receiving bank. The journal entry made, however, was to credit cash and debit an expense account (to fraudulently decrease 20X0 profits—perhaps to decrease taxes) rather than to debit cash in the receiving bank. On January 2, an entry was made to debit cash for the transfer and to credit a revenue account to correct the 20X0 misstatement, and to overstate the 20Y0 profits.</td>
<td></td>
</tr>
<tr>
<td>d. Correct</td>
<td>Book entries: On December 31 a check was written on the disbursing bank, recorded as a cash disbursement in the cash disbursements records and recorded as a receipt in the cash receipts records. The check was mailed to the receiving bank. Bank entries: The check was received by the receiving bank on January 2. On January 4, the check was received by the disbursing bank.</td>
<td></td>
</tr>
<tr>
<td>e. Correct</td>
<td>Book entries: On January 1 a check was written on the disbursing bank, recorded as a cash disbursement in the cash disbursements records and recorded as a receipt in the cash receipts records. The check was mailed to the receiving bank. Bank entries: The check was received by the receiving bank on January 3. On January 4, the check was received by the disbursing bank.</td>
<td></td>
</tr>
<tr>
<td>f. Overstated</td>
<td>Accounting entries: On December 31 a check was written on the disbursing bank to transfer cash to the receiving bank. The improper journal entry made, however, was to debit cash (in the receiving bank's account) and credit a revenue account (to fraudulently increase profits). On January 1, an entry was made to credit cash for the transfer and to debit an expense account to correct the 20X0 misstatement, and to understated the 20Y0 profits. Bank entries: The check was deposited in the receiving bank on December 30. On January 2 the check was received by the disbursing bank.</td>
<td></td>
</tr>
<tr>
<td>g. Overstated</td>
<td>Book entries: Earlier during the month that amount of cash ($42,000) had been stolen from the receiving bank. To conceal the shortage on December 31, the embezzler wrote a check transferring $42,000 from the disbursing bank to the receiving bank. The transfer was not recorded on the books until January 2 of 20Y0. Bank entries: The check was deposited in the receiving bank on December 31. On January 2 the check was received by the disbursing bank.</td>
<td></td>
</tr>
</tbody>
</table>
| h. Correct | (The total cash is correct here, but recorded in the wrong accounts as of year-end.) Book entries: Although a check is written on the disbursing bank on December 30, no entry was made on the books until January. For example, assume that a high level employee had a blank check, was authorized to sign it, and did to transfer the funds at year-end. She forgot to record it in the books until January 3 when she properly
Chapter 10 - Cash and Financial Investments

<table>
<thead>
<tr>
<th>CASE</th>
<th>Cash</th>
<th>Acct. Rec.</th>
<th>Inventory</th>
<th>CGS</th>
<th>Sales</th>
<th>Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Zhang Inc. left the cash receipts journal open after year-end for an extra day and included January 1 cash receipts in the December 31 totals. Periodic inventory. What effect would this have on 20X8?</td>
<td>$2,500 (o)</td>
<td>$2,500 (u)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Zhang Inc. closed the cash receipts journal at 12/29 and reported the last two days cash receipts in January of 20X9. Periodic inventory. What effect would this have on 20X8?</td>
<td>$7,000 (u)</td>
<td>$7,000 (o)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Zhang Inc. left the sales journal open after year-end for an extra day and included January 1 sales in the December 31 totals. Periodic Inventory. What effect would this have on 20X8?</td>
<td></td>
<td></td>
<td>$3,500 (o)</td>
<td>$3,500 (o)</td>
<td>$3,500 (o)</td>
<td>$3,500 (o)</td>
</tr>
<tr>
<td>4. Same as 3, but perpetual inventory.</td>
<td></td>
<td></td>
<td>$3,500 (o)</td>
<td>$2,200 (u)</td>
<td>$2,200 (o)</td>
<td>$3,500 (o)</td>
</tr>
<tr>
<td>5. Zhang Inc. closed the sales journal at 12/29 and reported the two last day's sales in January of 20X9. Perpetual inventory. What effect would this have on 20X8?</td>
<td>$3,000 (u)</td>
<td>$1,900 (o)</td>
<td>$1,900 (u)</td>
<td>$3,000 (u)</td>
<td>$1,100 (u)</td>
<td></td>
</tr>
<tr>
<td>6. Zhang Inc. left both the sales journal and the cash receipts journal open through January 2 and reported the first two days transactions in December of 20X8. Periodic Inventory. What effect would this have on 20X8?</td>
<td>$5,700 (o)</td>
<td>$5,700 (u)</td>
<td>$7,500 (o)</td>
<td>$7,500 (o)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Bank entries: The check was deposited in the receiving bank on December 30. Bank Account One recorded the disbursement on December 31, the day it was received.
Research and Discussion Case

10–50 SOLUTION: Suncraft Appliance Corporation  (Estimated time: 45 minutes)

The essence of this case is that certain forms of "window dressing" are permissible and are, in fact, undertaken by most audit clients. Other forms, however, are not acceptable; in fact, they might be interpreted by the courts as acts of fraud.

a. (1) **Talking customers into placing orders early:**
   This is an acceptable and commonplace form of "window dressing." In fact, many companies offer discounts in order to entice customers to place orders prior to year-end. As long as the transaction actually occurs within the current year, the auditors are hardly in a position to "reassign" it to a future period.

(2) **Shipping all orders received through December 31:**
   If this is "window dressing," it is virtually impossible to distinguish it from efficient operations. Again, as long as the transaction is executed within the current year, it is properly recorded within the current year.

(3) **Overshipping orders, assuming that returns will not occur until January:**
   An overshipment is not a sale. Goods must be ordered by the customer, not merely shipped by the vendor, for a legitimate sale to have occurred. This is not an acceptable form of "window dressing." Having heard this suggestion, the auditors should compare a sample of year-end shipments to the customers' purchase orders and also monitor sales returns in January to determine whether the client is engaging in this unacceptable practice.

(4) **Label orders unshipped as of December 31 as sold and record the sale:**
   This is another unacceptable form of "window dressing." A sale occurs when the title to the merchandise transfers from the seller to the buyer. Normally, this is f.o.b. destination, or f.o.b. shipping point. In either case, the merchandise must actually have been shipped by the seller. This proposal by the controller amounts to a cutoff error.

(5) **Record checks dated December 31 as cash receipts of that date:**
   This proposal is another cutoff error. The date to be used in recording a cash receipt is the date that the check is received, not the date that it was written. The auditors should trace the December 31 deposit in transit to the deposit shown on the next banking day in the cutoff bank statement.

(6) **Officer to repay loan from company, then renew loan:**
   This is a related party transaction, which would have to be fully disclosed in the company's financial statements. While the treasurer's repayment and renewal of the loan would be recorded in the company's accounts on the dates that the transactions occurred, it is probable that the adverse publicity generated by complete disclosure of this transaction would more than offset the beneficial change in the company's year-end cash position.

(7) **Date cash disbursements for current liabilities as of December 31, but do not mail the checks:**
   This is another unacceptable form of "window dressing." As the client has not actually released the checks, neither the balance of the Cash account nor of Accounts Payable should be reduced. To detect this improper scheme to increase the company's current ratio, auditors review the cutoff bank statement to determine that checks supposedly issued at year-end are clearing on a timely basis.
Defer the write-down of obsolete inventory until next year:

Given that the inventory is obsolete, this is an unacceptable suggestion. A loss should be recognized as soon as there is objective evidence that a loss has occurred. To defer the write-down to a future time period would distort the income of both time periods.

Delay purchase of machinery previously ordered for December:

Title to merchandise changes from the seller to the buyer at a specified date, usually the date of shipment or of delivery. If the transaction is delayed, the company may legitimately delay the recording of the purchase and the related liability until the transaction actually occurs. Thus, delaying a purchase is an acceptable form of "window dressing."

b. No. Auditors can never assure a client of an unqualified opinion until they have completed their examination. There are many situations beyond those discussed at the meeting that may necessitate the auditors issuing something other than an unqualified report.

c. Whether the discussion held by the client would cause the auditors to withdraw from the engagement is, of course, a personal decision. On the one hand, audit risk is increased because the client is in financial difficulty and has indicated a certain desperation to portray financial health in its financial statements. On the other hand, the client has been most straightforward in discussing these proposals in advance with its auditors. It has candidly sought the auditors' advice as to whether or not the proposed actions were legitimate. Our personal decision would not be to withdraw, but we would increase our cutoff procedures and other testing of year-end transactions. We also would devise audit procedures to test for every type of transaction that we recommend against at the meeting.

Ethics Case

The problem here is that you continue to have a difficult time meeting budget and Sarah has at least implicitly suggested that you begin to sign off audit steps without having performed them.

b. Possible courses of action include:

1. Follow Sarah’s approach. Following Sarah’s approach is likely to be effective in helping the accountant to meet the time budget. A difficulty is that it might be considered fraudulent, and at a minimum is dishonest. Attempt to get students involved in the issue of signing off “unimportant” versus “important” audit procedures. Students might argue that if this is only done for procedures that seem unnecessary the effect will be minimal. Yet a difficulty here is that the accountant may be wrong in assessing the importance of particular steps. Also, what quite possibly is an unrealistic budget probably remains for next year’s audit. If a particular audit step appears unnecessary, the accountant might discuss the situation with the in-charge senior who might choose to eliminate the step.

2. Do not follow Sarah’s approach. This approach allows the accountant to
maintain honesty and work performance. But the problem of not being able to get work done in the budgeted time remains.

c. We strongly recommend **not** following Sarah’s approach. This leads to dishonesty, unreasonable budgets for subsequent years, and perhaps misstatements that are not identified.

**Other Observations**

You might wish to extend the discussion at this point and ask whether students believe that the individual should tell someone in the CPA firm about Sarah’s approach. This has a tendency to lead to a discussion of whether it is appropriate to disclose to others information provided to you in confidence versus your responsibility to the firm.

In many accounting firms, standard auditing programs are ready for use. Since business processes vary from firm to firm, auditing programs need to be customized accordingly. Whenever accountants encounter a situation where standard program does not apply, discussions with audit team management are strongly encouraged.