Audit Responsibilities and Objectives

Chapter 6
Learning Objective 1

Explain the objective of conducting an audit of financial statements and an audit of internal controls.
Objective of Conducting an Audit of Financial Statements

The purpose of an audit is to provide financial statement users with an opinion by the auditor on whether the financial statements are presented fairly, in all material respects, in accordance with applicable financial accounting framework.
FIGURE 6-1  Steps to Develop Audit Objectives

- Understand objectives and responsibilities for the audit
- Divide financial statements into cycles
- Know management assertions about financial statements
- Know general audit objectives for classes of transactions, accounts, and disclosures
- Know specific audit objectives for classes of transactions, accounts, and disclosures
Learning Objective 2

Distinguish management’s responsibility for the financial statements and internal control from the auditor’s responsibility for verifying the financial statements and effectiveness of internal control.
Management’s Responsibilities

Financial statements and internal controls.

Sarbanes-Oxley increases management’s responsibility for the financial statements.

CEO and CFO must certify quarterly and annual financial statements submitted to the SEC.
Management’s Responsibilities

FIGURE 6-2 International Business Machines Corporation’s Report of Management

REPORT OF MANAGEMENT
International Business Machines Corporation and Subsidiary Companies

Management Responsibility for Financial Information

Responsibility for the integrity and objectivity of the financial information presented in this Annual Report rests with IBM management. The accompanying financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America, applying certain estimates and judgments as required.

IBM maintains an effective internal control structure. It consists, in part, of organizational arrangements with clearly defined lines of responsibility and delegation of authority, and comprehensive systems and control procedures. An important element of the control environment is an ongoing internal audit program. Our system also contains self-monitoring mechanisms, and actions are taken to correct deficiencies as they are identified.

The Audit Committee of the Board of Directors is composed solely of independent, non-management directors, and is responsible for recommending to the Board the independent registered public accounting firm to be retained for the coming year, subject to stockholder ratification. The Audit Committee meets periodically and privately with the independent registered public accounting firm, with the company’s internal auditors, as well as with IBM management, to review accounting, auditing, internal control structure and financial reporting matters.

Samuel J. Palmisano
Chairman of the Board,
President and Chief Executive Officer
February 23, 2010

Mark Loughridge
Senior Vice President
Chief Financial Officer
February 23, 2010
Management’s Responsibilities

The Sarbanes-Oxley Act provides for criminal penalties for anyone who knowingly falsely certifies the statements.
Learning Objective 3

Explain the auditor’s responsibility for discovering material misstatements.
Objectives of the Auditor

- Obtain reasonable assurance
- Financial statements
- Free from material misstatements
- Opine
- Financial statements
- Applicable reporting framework
- Report
- Financial statements
- Communicate per audit standards
Auditor’s Responsibilities

- Material misstatements
- Professional Skepticism
- Errors vs. Fraud
- Reasonable Assurance
- Fraudulent reporting vs. theft of assets
Auditor’s Responsibilities for Discovering Illegal Acts

**Type**

- **Direct-Effect**
  - Responsibility: Same for errors and fraud

- **Indirect-Effect**
  - Responsibility: No Assurance
Auditor’s Responsibilities for Discovering Illegal Acts

Auditor suspects
- Inquire of management
- Consult client’s counsel or specialist
- Consider accumulating evidence

Auditor knows
- Consider effects on financial statements
- Consider effect on relationship with management
- Communicate with audit committee or equivalent
Learning Objective 4

Classify transactions and account balances into financial statement cycles and identify benefits of a cycle approach to segmenting the audit.
Financial Statements Cycles

Audits are performed by dividing the financial statements into smaller segments or components.
Transaction Flow Example

FIGURE 6-3  Transaction Flow from Journals to Financial Statements

TRANSACTIONS
- Sales
- Cash receipts
- Acquisition of goods and services
- Cash disbursements
- Payroll services and disbursements
- Allocation and adjustments

JOURNALS
- Sales journal
- Cash receipts journal
- Acquisitions journal
- Cash disbursements journal
- Payroll journal
- General journal

LEDGERS, TRIAL BALANCE, AND FINANCIAL STATEMENTS
- General ledger and subsidiary records
- General ledger trial balance
- Financial statements
Relationships Among Transaction Cycles

- General cash
  - Capital acquisition and repayment cycle
- Sales and collection cycle
- Acquisition and payment cycle
- Payroll and personnel cycle
- Inventory and warehousing cycle
Learning Objective 5

Describe why the auditor obtains a combination of assurance by auditing classes of transactions and ending balances in accounts, including presentation and disclosure.
## Balance and Transactions Affecting Balances Example

### FIGURE 6-6

<table>
<thead>
<tr>
<th>Accounts Receivable (in thousands)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Beginning balance</strong></td>
</tr>
<tr>
<td><strong>Sales</strong></td>
</tr>
<tr>
<td><strong>Cash receipts</strong></td>
</tr>
<tr>
<td><strong>Sales returns and allowances</strong></td>
</tr>
<tr>
<td><strong>Charge-off of uncollectible accounts</strong></td>
</tr>
<tr>
<td><strong>Ending balance</strong></td>
</tr>
</tbody>
</table>
Learning Objective 6

Distinguish among the three categories of management assertions about financial information.
Management Assertions

1. Assertions about classes of transactions and events for the period under audit

2. Assertions about account balances at period end

3. Assertions about presentation and disclosure
## Management Assertions for Each Category of Assertions

<table>
<thead>
<tr>
<th>Transactions and Events</th>
<th>Account Balances</th>
<th>Presentation and Disclosure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Occurrence</td>
<td>Existence</td>
<td>Occurrence and rights and obligations</td>
</tr>
<tr>
<td>Completeness</td>
<td>Completeness</td>
<td>Completeness</td>
</tr>
<tr>
<td>Accuracy</td>
<td>Valuation and allocation</td>
<td>Accuracy and valuation</td>
</tr>
<tr>
<td>Classification</td>
<td></td>
<td>Classification and understandability</td>
</tr>
<tr>
<td>Cutoff</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Rights and obligations</td>
<td></td>
</tr>
</tbody>
</table>
## PCAOB Assertions

<table>
<thead>
<tr>
<th>Assertions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Existence or Occurrence</td>
</tr>
<tr>
<td>Completeness</td>
</tr>
<tr>
<td>Valuation or allocation</td>
</tr>
<tr>
<td>Rights and obligations</td>
</tr>
<tr>
<td>Presentation and disclosure</td>
</tr>
</tbody>
</table>

Similar to U.S. GAAS as the first four assertions are applicable to balances and transactions. Presentation is treated as a single assertion.
Learning Objective 7

Link the six general transaction-related audit objectives to management assertions for classes of transactions.
General Transaction-related Audit Objectives

- **Occurrence**: Recorded transactions exist
- **Completeness**: Existing transactions are recorded
- **Accuracy**: Recorded transactions are stated at the correct amounts
General Transaction-related Audit Objectives

- **Posting and summarization**: Transactions are included in the master files and are correctly summarized.

- **Classification**: Transactions are properly classified.

- **Timing**: Transactions are recorded on the correct dates.
# Hillsburg Hardware Co.

(Applied to Sales Transactions)

## TABLE 6-3

<table>
<thead>
<tr>
<th>Management Assertions About Classes of Transactions and Events</th>
<th>General Transaction-Related Audit Objectives</th>
<th>Specific Sales Transaction-Related Audit Objectives</th>
</tr>
</thead>
<tbody>
<tr>
<td>Occurrence</td>
<td>Occurrence</td>
<td>Recorded sales are for shipments made to nonfictitious customers.</td>
</tr>
<tr>
<td>Completeness</td>
<td>Completeness</td>
<td>Existing sales transactions are recorded.</td>
</tr>
<tr>
<td>Accuracy</td>
<td>Accuracy</td>
<td>Recorded sales are for the amount of goods shipped and are correctly billed and recorded.</td>
</tr>
<tr>
<td></td>
<td>Posting and summarization</td>
<td>Sales transactions are properly included in the master file and are correctly summarized.</td>
</tr>
<tr>
<td>Classification</td>
<td>Classification</td>
<td>Sales transactions are properly classified.</td>
</tr>
<tr>
<td>Cutoff</td>
<td>Timing</td>
<td>Sales transactions are recorded on the correct dates.</td>
</tr>
</tbody>
</table>
Learning Objective 8

Link the eight general balance-related audit objectives to management assertions for account balances.
General Balance-related Audit Objectives

Existence: Amounts included exist

Completeness: Existing amounts are included

Accuracy: Amounts included are stated at the correct amounts
General Balance-related Audit Objectives

- **Classification**: Amounts are properly classified
- **Cutoff**: Transactions are recorded in the proper period
- **Detail tie-in**: Account balances agree with master file amounts, and with the general ledger
General Balance-related Audit Objectives

Realizable value

Assets are included at estimated realizable value

Rights and obligations

Assets must be owned
# Hillsburg Hardware Co.

(Applied to Inventory)

<table>
<thead>
<tr>
<th>Management Assertions About Account Balances</th>
<th>General Balance-Related Audit Objectives</th>
<th>Specific Balance-Related Audit Objectives Applied to Inventory</th>
</tr>
</thead>
<tbody>
<tr>
<td>Existence</td>
<td>Existence</td>
<td>All recorded inventory exists at the balance sheet date.</td>
</tr>
<tr>
<td>Completeness</td>
<td>Completeness</td>
<td>All existing inventory has been counted and included in the inventory summary.</td>
</tr>
<tr>
<td>Valuation and allocation</td>
<td>Accuracy</td>
<td>Inventory quantities on the client’s perpetual records agree with items physically on hand. Prices used to value inventories are materially correct. Extensions of price times quantity are correct and details are correctly added.</td>
</tr>
<tr>
<td>Classification</td>
<td>Classification</td>
<td>Inventory items are properly classified as to raw materials, work in process, and finished goods.</td>
</tr>
<tr>
<td>Cutoff</td>
<td>Cutoff</td>
<td>Purchase cutoff at year-end is proper. Sales cutoff at year-end is proper.</td>
</tr>
<tr>
<td>Detail tie-in Realizable value</td>
<td>Detail tie-in Realizable value</td>
<td>Total of inventory items agrees with general ledger. Inventories have been written down where net realizable value is impaired.</td>
</tr>
<tr>
<td>Rights and obligations</td>
<td>Rights and obligations</td>
<td>The company has title to all inventory items listed. Inventories are not pledged as collateral.</td>
</tr>
</tbody>
</table>
Learning Objective 9

Link the four presentation- and disclosure-related audit objectives to management assertions for presentation and disclosure.
<table>
<thead>
<tr>
<th>Management Assertions About Presentation and Disclosure</th>
<th>General Presentation- and Disclosure-Related Audit Objectives</th>
<th>Specific Presentation and Disclosure-Related Audit Objectives Applied to Notes Payable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Occurrence and rights and obligations</td>
<td>Occurrence and rights and obligations</td>
<td>Notes payable as described in the footnotes exist and are obligations of the company.</td>
</tr>
<tr>
<td>Completeness</td>
<td>Completeness</td>
<td>All required disclosures related to notes payable are included in the financial statement footnotes.</td>
</tr>
<tr>
<td>Accuracy and valuation</td>
<td>Accuracy and valuation</td>
<td>Footnote disclosures related to notes payable are accurate.</td>
</tr>
<tr>
<td>Classification and understandability</td>
<td>Classification and understandability</td>
<td>Notes payable are appropriately classified as to short-term and long-term obligations and related financial statement disclosures are understandable.</td>
</tr>
</tbody>
</table>
Learning Objective 10

Explain the relationship between audit objectives and the accumulation of audit evidence.
How Audit Objectives Are Met

The auditor must obtain sufficient appropriate audit evidence to support all management assertions in the financial statements.

- An audit process has four specific phases
## Four Phases of a Financial Statement Audit

<table>
<thead>
<tr>
<th>Phase</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>Plan and design an audit approach</td>
</tr>
<tr>
<td>II</td>
<td>Perform tests of controls and substantive tests of transactions</td>
</tr>
<tr>
<td>III</td>
<td>Perform analytical procedures and tests of details of balances</td>
</tr>
<tr>
<td>IV</td>
<td>Complete the audit and issue an audit report</td>
</tr>
</tbody>
</table>
End of Chapter 6